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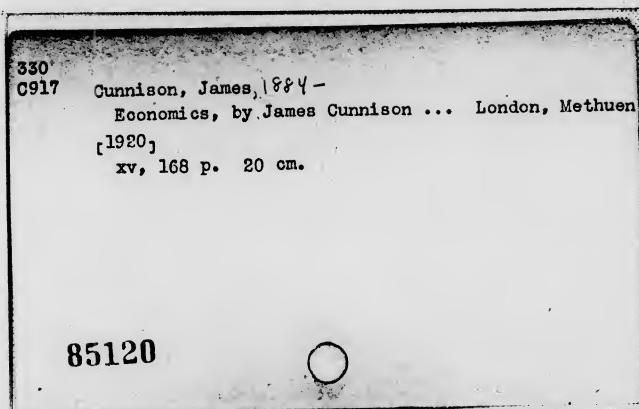
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ECONOMICS

ECONOMICS

BY

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METHUEN & CO. LTD.
36 ESSEX STREET W.C.
LONDON

20-51155

First Published in 1920

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File No. 45-19 "A"

TO
THE MEMORY OF
MY FATHER

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INTRODUCTION

ECONOMICS examines the thoughts and actions of groups of men in making, acquiring, and using wealth.

Man's welfare consists of his activities and of his enjoyment of the results of his activities. As father, neighbour, or citizen, he finds his satisfaction in the mere exercise of his powers and sympathies. But he goes to his daily work not primarily from an interest in the work itself, but in order to earn the necessities, comforts, or luxuries which he believes to be essential or contributory to his welfare. So far as he makes these his object, his interest lies not in the activity but in its outcome. What might otherwise be recreation becomes work; for it has to be done under conditions not of his own choosing, to which he submits because only thus can he obtain the wealth which he seeks. At the outset, then, we must try to get some general conception of the nature of this wealth and of the ways in which he seeks it.

(a) Wealth is relative to man and to his conception of well-being. How far welfare is externally conditioned it is not our business here to determine. It is enough for our purpose to note that to be wealth in the economic sense of the term a thing must meet some human want or satisfy some human desire. As such it may be a material thing or an immaterial service: it may be a loaf of bread, or a suit of clothes, or the services of doctor,

teacher, or actor. In any case it is wealth only so far as it seems good and desirable to some one.

But not everything of this kind is wealth. Wealth does not include those things which are so plentiful that no effort or sacrifice is required in order to obtain them. In normal circumstances, for instance, the air we breathe is not reckoned as wealth. But if we found ourselves in a Black Hole of Calcutta we might be willing to mortgage the rest of our working lives, or to sacrifice all our possessions in return for air. Its scarcity would make it wealth.

Thus, to be a part of wealth, a thing must meet two requirements : it must be capable of satisfying a want ; and it must not be available in such abundance that its acquirement involves no effort. Anything whatever which satisfies these conditions is wealth, whether it be the rag on the beggar's back or the robes of a princess.

In the modern world men tend to identify wealth with money ; because normally the possession of the latter is the condition of the possession of the former, and under the normal circumstances of the present time, money is a part of wealth, for it satisfies desire and it cannot be obtained without effort. But it is not always wealth ; and it can never be the whole of wealth. The war-time experience of most European countries ought to have convinced us of this fact, even if we had never heard the story of Midas. Money is wealth only when it can be exchanged for bread and butter, clothes and houses, books, furniture, and the many things we desire for the satisfaction of our wants. These alone are the real items of wealth ; and if the reader is beginning the study of economics, he would do well to forget for a

time the existence of money, and to think of wealth in terms of the actual things of which it consists.

So much for the bare conception of wealth. But man, being a creature who looks before and after, reckons his welfare not merely by his possessions at a moment of time, but by his expectation of a continuous command over wealth. And when we compare the wealth of individuals or of nations and call one poor and another rich, we take into account not a stock of things existing at a moment of time, but a continuous flow of things which come into being over a period of time. Wealth as *income* is a more illuminating conception than wealth as a fixed stock of goods.

All wealth is income. We lose sight of this fact because we limit our observation to brief periods, and see what appear to be two kinds of wealth. We see things which appear to be more or less permanent—factories, houses, machinery ; and we see things which issue from these and have a shorter life—food, clothing, etc. We call the former capital and the latter income. But the difference between the two types of things is only one of degree. The oldest building was erected at some time and will ultimately fall into decay. All the wealth that exists at any moment has appeared once as new wealth and has had to be produced. This feature we must constantly keep in mind.

(b) The economic organization of any community, then, is directed to the continuous production of the goods and services that satisfy human desire. This organization may be simple ; or it may be highly developed and complex. In the primitive community each man performs the direct actions necessary to growing his daily food. In the modern advanced community

he becomes part of an intricate system, each part of which is joined up by endless ramifications with other parts. The obvious business of wealth production becomes the occult business of finance, marketing, transport, manufactures, each of which has its problems. The ordinary man of to-day, in order to "make a living," must go to work. But he does not go to work on the things he wants—on making bread, houses, or clothing. Instead he goes, let us say, into a shipyard, where he works along with some hundreds of others in the work of ship-building. No one of these men wants a ship for himself : and none of them could in a life-time build a complete ship. Each contributes his specialized skill, particular organizing powers, knowledge or ability to the making of a ship for some one else. He is paid for his labour, and with his payment buys the things he wants. This roundabout method of making his living contrasts with that of the primitive man who builds a boat only if he wants one ; who works alone, and with his own hands fells a tree and hollows it into shape ; who receives no wages, but has his boat for payment ; and who, having completed his boat, becomes in turn hunter, fisher, or hut-builder.

The ultimate stimulus to the development from a simple to a complex system of economic organization has been the pressure of a population, naturally prolific, on nature, who is niggardly in her gifts. Not that an abundance of wealth, procured with little exertion, necessarily leads to sloth or inactivity: that is universally true neither of peoples nor of classes. But in such cases, activity is devoted to ends which are not economic. On the other hand development, even in the economic sphere, may indirectly result from such non-economic

activities. Modern industry owes much to the work of adventurers in the realm of pure science. Nevertheless much economic progress has been necessitated by the tardiness of nature's response to man's advances.

The main line of advance on this long journey from the simple to the complex has been the application of the principle of Division of Labour. It began when one man applied himself to one occupation and left others to his fellows. It has continued down to the period of the world-war, when, in the engineering and other industries, the complicated work of the skilled craftsman was split up into its simple constituent movements, each of which can be performed by an unskilled worker with or without the aid of machinery. This division of labour brings with it the other outstanding features of the advanced economic organization. It implies exchange, for one man could not specialize in one product if others did not specialize in something else, and if there were not some understanding between them to exchange their respective products. Exchange implies value, which is another name for the ratio in which things exchange for one another ; and if value is to be accurately measured, it necessitates the introduction of money. Again, when the work of a community is done by specialized groups of men, some one is required to bring the various workers together, and to give each his task ; in other words, to organize the work. And as soon as specialized men work in groups under an organizer, they cease to have a proprietary interest in the things they produce. The shipwright, the sailmaker, and the ship's painter do not carry off with them, as the product of their labour, so many yards of sail-cloth or so many parts of the ship. They receive from the organizer a

payment in money which represents the value of their labour. The total anticipated value of the ship is distributed among the several people who have contributed to its construction, including the organizer himself.

Economics deals with these divisions of man's endeavour to meet his wants. It examines the production of wealth, and the division of labour and the organization which it implies; the nature of exchange and the laws that govern value, and the principles on which the products of a community are distributed among individuals.

There are many ways in which we might regard these various aspects of economic life. We might look at them historically, tracing their origin and development; and economic history is important not only from its inherent interest, but because of the light it throws on existing conditions. Or we might test economic institutions by some ethical standard, with the object of justification or condemnation. Or we might deal with the subject normatively, suggesting ways in which the economic life of the community ought to be developed with a view to maximum output, or maximum human happiness, or some other declared end. But our object in this book is to take the economic system as we find it, to try to understand it and see how it works. We shall assume the existence of the system under which the economic life of the great western communities, the United Kingdom, the United States, France, and Germany is carried on: the system, that is, which is based on private property and economic freedom, and has consequently as its motive force the competition of individuals in their desire for private gain. But since economic freedom includes freedom to associate as well as freedom

to compete, we shall have to note the tendency towards industrial combination; a tendency, however, which by no means eliminates competition, either between individuals, or, except in the extreme case of pure monopoly, between industrial units, but which leads to the action of competition on new levels. And since the exigencies of war time resulted in a degree of State control of economic activities hitherto unknown, we shall have to inquire how far that control is likely to be permanent, and to what extent it heralds the beginning of a new era in which the regulation of economic forces by external authority will supersede the economic freedom of the individual.

ECONOMICS

PART I

THE MAKING OF WEALTH

CHAPTER I

THE SOURCES OF WEALTH

The Wealth of the World and of Individuals

IN the same community one man is poor and another wealthy. The conditions that lead to this difference in material welfare are partly economic: the rich man may work harder or perform more useful service than the poor. But they are partly legal, for the existence of laws of inheritance gives one man a better start in life than another. To explain differences in individual wealth, then, we have to look not merely to economic forces but to existing social and legal conditions. But to explain why a large group of people, like a nation, or humanity, is poor or wealthy, we need in the main attend only to the general conditions of the production of wealth, and we may ignore the causes which lead to its unequal division between individuals. Necessary modifications of this general statement will become apparent as we proceed.

Early writers on economics emphasized the distinction between the wealth of different groups of people separated by political boundaries. Adam Smith's theme was "The Wealth of Nations." So long as nations were

separated—by national enmity, by geographical features, by the lack of transport and communication, or by economic barriers—the conditions of the growth of wealth in one country were fundamentally different from those in another, and it was natural to draw attention to the elements of difference rather than to the common elements in the production of wealth. But the time has now passed for such distinctive treatment: nations are no longer economically islands. Knowledge, wealth, capital, labour, inventions, and discoveries can, and do, flow more or less freely from one country to another. The problem of the growth of wealth has become a problem common to all the nations, and one which can be tackled by international co-operation better than by international rivalry. Again, it is useless to ignore distinctions; but the emphasis is changing.

In Part I of this book we deal in the main with the common conditions of the production of wealth in general. In later portions we shall have to look at problems of relative wealth or poverty of individuals and particular groups of people.

The Meaning of Production

Bearing in mind the nature of wealth, as defined in the introduction, we see that production must be the making of things fit for human consumption; and all effort which results in making a useless thing useful, or bringing a distant thing near, is of the nature of production. No work can do more than this. In no industry are things created: if there is creation at all, it is creation of useful properties, or, in technical terms, of *utilities*. The various workers who transform the wool from the sheep's back into a garment have not created any material part of the garment, but they have created its "wearableness." They have made it fit for human consumption. *Production*, then, is the *making of utilities*; and this is the characteristic common to all industries, agricultural, mining, transport, or manu-

facturing. So far, then, as any work is necessary to bring a commodity into the hands of the consumer in useful form, and when it is wanted, it is productive work.

In ordinary speech a distinction is constantly drawn between productive and unproductive labour. As far back as the eighteenth century a group of French Economists, the Physiocrats, made such a distinction, holding that agricultural labour alone was productive, because it alone resulted in new wealth. Adam Smith moved the line of cleavage forward; he held that all labour which issued in material goods capable of accumulation was productive; but that all services were unproductive because no concrete thing capable of accumulation resulted from these services. He therefore held that manufactures should be in the same class as agriculture, but that the work of teachers, governors, etc., was unproductive.

The present tendency among economists is to say that all labour is productive *in intention*, since it is all aimed at the making of utilities; and that labour is unproductive only if it is misdirected or fails in its intention. But this view ignores popular judgment, which, though often unreasoned, is persistent. It seems most satisfactory to say that, given a certain stage of economic life, all *classes* of labour are productive. At present, for instance, the "middleman" is productive no less than the farmer; for without him goods would not reach the consumer as conveniently as they do. But with slight modifications in economic organization many individual middlemen might be easily dispensed with, without any reduction in the wealth of the world, and without inconvenience to the consumer. The combination of formerly rival firms frequently leads to an economy in agents and advertisers.

The Conditions of Production

In order that any wealth may be produced at all two bare conditions are essential. These are, the output

of effort on the part of human beings and the existence of certain resources given by nature. The active factor is human effort, or *labour*—whether of hand or mind or will. Without it, no wealth would be produced. On the other hand, by itself it could produce no wealth. It requires natural resources to work on. Even the teacher, the writer, or administrator requires some materials to aid him, and his foot of earth on which to stand. These *natural resources* consist of the surface of the land, for growing crops, or bearing animals, or for the erection of buildings; the minerals beneath the soil; the warmth and moisture of the air; and the waters of the earth—sea, lake, and river.

Given those two factors, labour and natural resources (or *land*, in the wide meaning of the word), some wealth can be produced. But the amount that can be produced depends on the quantity and quality of labour and land; and on the possession by man of instruments to help him in his work. Such instruments in the advanced community are known as *capital*, and form an important factor in wealth production. Let us examine these three factors.

Natural Resources

The growth of wealth in any community, then, depends first on the quantity and quality of natural resources available. If the area is isolated, its potential wealth will vary with the *extent* of the available land surface; its *fertility* for crop-bearing or stock-raising; the existence of *mineral deposits*, and the presence of *sources of power*, like water and coal. Given such conditions the welfare of the people will vary with the *diversity* of the qualities of the land, for a land which is not only fertile but has mineral deposits will yield greater wealth to a self-contained community than if it was only fit for crops.

If, on the other hand, the country is in communication with others commercially, it will be more important that it should be able to produce certain things easily

and cheaply and exchange them for the products of other countries. Geographical position will in this case be the chief point of practical interest.

How Land is Limited

Nature has set certain limits to land. It is absolutely limited in extent, and in the amount of its mineral deposits. These limits may be remote. Of much greater practical bearing is its relative limitation as a factor of production. Produce can only be raised by the expenditure of labour and capital, and the amount of produce land will yield to any given expenditure is limited. Some lands will yield more than others, but no piece of land will yield an indefinite produce. Moreover, concentration of effort on any one field does not result in an increase of produce proportionate to the increased effort and expenditure. Two men raise a certain quantity, but a hundred men, working on the same field, under the same conditions, will not raise fifty times as much. The fertility of land is limited.

This phenomenon is so important that we must write it in *italics*. *The returns which land yields to successive equal applications of labour and capital tend to diminish.*

But there are two cases in which this tendency does not show itself. First, in absolutely new lands, returns, up to a point, increase more than proportionately in response to increased effort. But the maximum point is soon reached. Secondly, man can stimulate nature to improved fertility by the introduction of new methods, scientific manures, and new processes of cultivation. But sooner or later the tendency will again assert itself on the new level, unless improvements of cultivation are continued. This statement will be modified at a later stage.

Labour

The growth of wealth depends, in the second place, on the human factor, labour, the supply of which in a

community varies with the *numbers* of the people and the productive qualities of each. It is not merely a problem of total population. Since every human being must consume, the existence of an idle class—whether rich or poor—is a drain on the wealth of the community. Hence the age distribution of the people affects its productivity; any event, such as a war, which reduces the number of the people in the prime of life, while leaving the old and the young alive, means a reduction in the wealth per head produced in the community. Further, the amount of wealth will also depend on whether certain sections of the people prefer to devote themselves to work which is not strictly economic.

The *qualities* of the people which make them more or less productive, are chiefly qualities of mind and will. Interest in economic pursuits, alertness, activity, power to adapt themselves to circumstances, accurate and rapid judgment and decision are the qualities which will enable a people to make the best use of their resources. The quality of mere physical strength tends, as economic life develops, to lose the important place it at first assumes.

But, in addition to numbers, and their possession of the best qualities, the greatest results cannot be achieved without co-operation. This we shall consider in the next chapter.

The Heritage from the Past

Each generation leaves as a heritage for its successor a certain material and spiritual environment, which includes knowledge, a political and social system, sanitary and medical conditions, and accumulated material wealth in the form of buildings and aids to production. All such inherited conditions are the foundations on which each generation builds; and they all affect the material welfare of a people. But the most directly important element in such accumulations is capital: the stored-up wealth, in the shape of tools,

machinery, factories, and railways, that enable man, with a given amount of labour, to produce greater quantities of wealth.

These three factors then are necessary for production; and a country will be rich or poor according to the amount and excellence of each factor it possesses. But there are always certain proportions of each which give the best combination. A plentiful supply of really fertile land will lead to little wealth if there are few men to work it. Keen, alert, and active labour will always be at a disadvantage with insufficient capital. At any time, the maximum production can be attained only with the right proportions of the three factors.

The Problem of Population

The problem of the population and the land supply must be considered together. We have to ask, What is the most desirable density of population?

In recent times the problem has not seemed vital; for the history of the nineteenth century was one of increasing wealth per head in spite of rapidly increasing population; but it is not very long since the problem was considered to be urgent; and although no longer stated in bald terms, the belief in a possible pressure of population on subsistence at no very remote time is implied in arguments on economic policy.

The Position of Malthus

The urgency of the problem was first brought home to the people by Malthus, whose famous "Essay on Population," appeared in 1798. It was in England a time of great poverty brought about by a rapidly increasing population, together with a series of bad harvests and high taxation. The appalling conditions impressed Malthus with the belief that a general improvement in the lot of mankind could never be looked for; and the doctrines being preached in his day promising the perfection and happiness of man in a reformed

state of society seemed to him absurd. His essay on population was, in its first form, built up as a refutation from facts, of the easy optimism of those writers.

The steps in the argument are these :—

1. The rate of increase of population (unchecked) is greater than the rate of increase in the means of subsistence.
2. Hence the population will be reduced by starvation unless its growth is checked in some other way.
3. But all other checks (war, pestilence, murder, etc.) resolve themselves into vice or misery.
4. Therefore the perfection of the human race is impossible. Q.E.D.

The points which must be examined in this argument, if we are to see this problem in the light of present facts, are three: (a) the natural rate of increase of population; (b) the rate of increase in the means of subsistence, and (c) the nature of the possible checks to population.

To illustrate the rate at which population would naturally increase apart from checks, Malthus instanced the northern States of America in which "the population" had "been found to double itself, for above a century and a half successively, in less than twenty-five years," from which he drew the conclusion that "population, when unchecked," would go on "doubling itself every twenty-five years." The contention, therefore, is that where means of subsistence are abundant, such rapid propagation would prevail, and it is only the lack of material wealth that keeps down numbers.

Since the time of Malthus there has been abundant opportunity of observing within our own country the relative rates of increase where material goods are plentiful and where they are scarce. It is a notable fact that the highest rate of propagation is found not among the wealthy or the comfortable, who have possession of all the means of subsistence necessary, but among the poorest whose incomes are scarcely

sufficient to keep body and soul together. Moreover, the increasing comfort of the mass of the people during the nineteenth century was accompanied not by an acceleration but by a retardation of the rate of natural increase (*i.e.* the births minus the deaths). And it is fairly established, that the greater foresight and self-respect which increasing prosperity brings with it, leads to a diminution rather than an increase in the rapidity of growth of population.

The Increase in the Means of Subsistence.—It is evident from Malthus' statement that he had not made himself acquainted with the facts of diminishing returns in agriculture which had already been pointed out in his day. His own account of the rate of increase of material wealth is vague. "Let us suppose," he says, "that the . . . produce of this island could be increased every twenty-five years by a quantity equal to what it already produces. The most enthusiastic speculator could not suppose a greater increase than this." On this basis he asserts that "the means of subsistence could not possibly be made to increase faster than in an arithmetical ratio." Hence, since population could, unchecked, double itself every twenty-five years, it "would increase as 1, 2, 4, 8, 16 . . .," but "subsistence as 1, 2, 3, 4, 5 . . ." If we accept such a comparison, it is clear that after the second twenty-five years, population would have outgrown subsistence; and therefore the problem seemed to Malthus one of immediate importance.

It would be easy to pick holes in his mathematics; but the question is whether he was right in his general contention that the food supply will not always keep pace with the growth of the people. That he was unnecessarily alarmed by the imminence of catastrophe has appeared from the history of the nineteenth century. But that was a history he could not have foreseen. The growth of the means of transport opened to this country the gates of a new world, with virgin fields of

great fertility. It must nevertheless be remembered that such an expansion in means of transport, such discoveries of new lands and new sources of supply are not likely to recur. And while we may look for continued inventions in agricultural machinery, and new methods of cultivation, it is likely that they will have to be applied to intensive and not to extensive cultivation.

Checks to Population

It appears, then, that there is a real ultimate problem of the density of population; and that it may not be so ultimate as the facts of the nineteenth century tended to suggest. But in the meantime the interest in that ultimate problem has been outweighed by the needs of the next decade. Europe has experienced a sudden reduction of its population through the action of one of the positive checks to population on which Malthus laid stress in his first edition. The result of the war has been a considerable reduction in the population of Europe, and the countries of Middle Europe are still having their numbers reduced in an unprecedented degree by the starvation of children. The era of the occurrence of the "positive checks to population" is not yet over.

In later editions of his essay Malthus allowed for the existence of a different kind of check to population which he had not considered in his first edition—namely, the "preventive check" of moral restraint, acting through the postponement of marriage to a later age, and the consequent reduction in the size of families. He agreed that with increasing comfort and prosperity this "preventive check" acted more potently, and that this would prevent the immediate occurrence of the catastrophe which he had feared. By allowing for the action of this positive check, he brought his statement of the facts of population more into line with actuality; but he made his essay lose point as a refuta-

tion of the theory of the perfectability of the human race.

As an immediate problem the question of density of population has for the present generation lost much of its urgency. But the war in sweeping away three-quarters of a million of our population selected those who were most valuable from the productive point of view; it also at the same time destroyed much of our material wealth. If the danger of the "pressure of population on subsistence" is to be indefinitely postponed, it will only be by the improvement of labour and a constant advance in the means of production.

To these two questions we apply ourselves in the following chapters.

CHAPTER II

THE PRODUCTIVE EFFICIENCY OF LABOUR

Factors in Efficiency

GIVEN a certain working population, its efficiency in production will depend on two factors: (*a*) the efficiency of each worker, considered as an isolated individual; (*b*) the degree to which individuals combine specialized powers in the work of production.

We have already pointed out the general physical and mental conditions which make for productivity. We have now to see how labour can be trained to yield the best results. We deal here with the large body of "wage-earning" labour. The labour of organization will be examined in Chapter V.

The Efficiency of the Individual

The kind of training which is necessary to make the individual an efficient producer depends on the kind of product required and the stage of economic development of the society in which he lives. Great physical strength and endurance, cunning, and all-round dexterity are the qualities most necessary in a primitive stage of life, when work has not been specialized and when man has to struggle daily with the elemental forces of nature. The training for such a life is a stern and ruthless one, in which only the fit survive. But with the development of economic life, and the specialization of men into different trades, what is wanted is that each man should undergo a continuous training to fit him to take some special part in the work of production. In England this training used to be gained during a lengthy period

of apprenticeship, during which the man acquired a certain kind of dexterity and learned to meet the special set of problems which presented themselves daily in his work. He thus built up a body of experience on which at any time he could fall back for guidance. He became skilled in his work; and acquired a "mystery" which was hidden from the unskilled. But with the continued division of labour and the development of machinery, the need and desire for such an extended training has diminished. What is wanted to-day is not so much specialized skill of a high order as general intelligence, alertness, and resource: and such training is to be got not only in the workshop but in the elementary, the continuation, and the technical school. The general technical education of the youth has taken and will increasingly take the place of apprenticeship and specialized training.

The need for physical strength, and for such training as only an apprenticeship can give, has not disappeared. But the emphasis has changed.

Co-operation and the Division of Labour

A necessary condition of the increased skill of the individual producer is, that he should be able to specialize in one kind of work. A Jack-of-all-trades is master of none. This specialization is one aspect of the general fact of co-operation, the development of which is the distinctive mark of advanced as compared with primitive industry.

Co-operation may be *simple* or *complex*. When two men combine to move a weight which neither could move by himself, the fact that they are co-operating is obvious, and the advantages of that method are plain. In felling trees, pulling ropes, and moving weights simple co-operation is still of importance in industry.

But complex co-operation is much more important. Where it exists the obvious fact is no longer the co-operation of individuals, but their specialization on

separate tasks ; and for this reason the term *division of labour* is more commonly used to describe it. This first takes the shape of broad divisions into separate trades. But these trades later become subdivided, and each subdivision is still further split up into processes, and processes into their simple component operations, in which the same movement or single set of movements is constantly repeated. As this network of divided labour becomes more intricate, and each man is confined to a single minute portion of the great work of production, it becomes less and less obvious to the spectator that these individuals are co-operating to a common end ; and the worker himself is seldom aware of the exact purpose of his labour. Nevertheless the co-operation and not the division of labour is still the important fact.

Forms of Productive Effort

As a result of the development of division of labour the productive work of the community is now split up into classes, which can be grouped for study on two distinct but equally natural principles. Different kinds of productive work may be classified (*a*) according to their product. The first great division, from this point of view, is between work which issues in material things, and work whose results have no material embodiment. The former includes industries of all kinds. To the latter belongs the work of those who perform services : the work of the administrator, doctor, teacher, of telephone girls, and servants. These kinds of work are called professions and services. It is obvious that industries of some kinds are essential before professions of any kind can exist. If some people did not devote themselves to making more food, clothing, and shelter than they themselves require, others could not spend all their energies in teaching or governing.

Confining our attention now to material production, we see natural groupings of people according to the

things they help to produce. These main groups are engaged in agriculture, mining, manufactures, etc. Each is further split up into further groups engaged in the production of single articles or classes of articles. Agriculture may be dairy farming or wheat producing ; manufactures include textiles, metals, and so on. When we ultimately reach the single factory we may find it wholly engaged in producing one article or even a single part of an article. All these industries, engaged in material production, may be classified as Primary or Secondary ; the former being in direct contact with the natural sources of wealth, and engaged in stimulating nature to produce, or extracting the stored-up wealth deposited in the earth ; the latter being engaged in working up the raw materials drawn from nature by the primary industries and making them fit for human consumption. We may therefore tabulate economic activities as follows :—

- | | |
|--------------------------------|--|
| 1. <i>Primary Industries</i> | $\left\{ \begin{array}{l} \text{Agriculture.} \\ \text{Fishing.} \\ \text{Hunting.} \\ \text{Mining.} \\ \text{Timber-cutting.} \end{array} \right.$ |
| 2. <i>Secondary Industries</i> | $\left\{ \begin{array}{l} \text{Manufactures.} \\ \text{Transport.} \\ \text{Distribution.} \end{array} \right.$ |
| 3. <i>Services.</i> | $\left\{ \begin{array}{l} \text{Teaching.} \\ \text{Governing.} \\ \text{Medicine.} \\ \text{Etc.} \end{array} \right.$ |

(b) *Groupings according to Nature of Work.*—The workers in the different industries, professions, and services just tabulated may be classified according to the nature of the work which they perform. A rough division is into manual and non-manual workers, or

those who work chiefly with their hands or chiefly with their heads. These again are capable of further division according to whether the work involves little skill or training ; or involves skill of a routine or repetitive character ; or demands independent thought and judgment. These are broadly classed respectively as unskilled, semi-skilled, or skilled ; but it is obvious that they merge into each other. In addition, in every industry and profession there is need for work of a highly original kind—the work of organizing, investigation, and research, which alone carries industry into new fields.

Thus the productive workers of the world are divided from each other by vertical and horizontal lines of cleavage. Working from bottom to top, there are grades of labour. The unskilled is separated from the skilled, the skilled worker from the organizer, and so on. In each grade there are divisions on the same level. Skilled workers may be engineers, or textile workers, or engaged in shipbuilding. But in each grade and industry the various specialized workers work into each other's hands and co-operate in the work of production.

Effects of the Division of Labour

Division of labour is thus a fundamental fact of modern industry and it explains the complexity of the business of producing even the simplest commodity. It can have been introduced so universally only on account of its beneficial effects on production. Let us examine these effects.

Direct Effects on Individual Output.—The division of labour has certain direct obvious effects on the productivity of the individual worker. (a) Since practice makes perfect, specialization leads to increased rapidity and accuracy in the execution of a task. (b) It saves time ; for the worker need not learn a multiplicity of processes, but can confine himself to a group of allied activities. These facts would be of importance if men were all born with equal abilities and aptitudes ; for all

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powers are capable of development. But the inequality of powers, and the diversity of interests of men, give to division of labour an added importance. By its means men can specialize in the work for which they have special abilities, and need not spend their lives in work in which they have neither aptitude nor interest. But it should be noted that the wisest distribution of work between individuals is not necessarily one in which every task is performed by the person best fitted to perform that task. In a small community an individual might be best fitted for several different kinds of work ; but it would not be wise for him to undertake them all. It might be more economical that he should perform one of them, and that some one not so well fitted as he should perform another. This feature will be noted later when we deal with international trade.

Machinery.—As soon as complex operations become split up into a series of simple movements, they are ready to be taken over by machinery ; and the machine is introduced to co-operate with, or to take the place of man. The effect of machinery on production is to increase output. At first, when the machinery was operated by human labour the increase was sufficiently great ; but since it has been harnessed to water, steam, and electric power, the multiplication of production is enormous. On labour, the effect is two-fold ; it leads to an increase of division of labour, not only by the further specialization of processes which it makes possible, but also through its bringing into being new industries for the production of machinery. On the other hand, so far as men continue to co-operate with machinery, they need no longer be highly skilled, highly trained men ; they become machine minders ; and the qualities demanded of them are general intelligence, some mechanical knowledge and alertness. In the great post-war steel-smelting works, few human beings are to be seen. Only here and there sits a man, apparently inactive, but with his sub-consciousness alert to detect the faintest

change in the note of the machinery, which he can control by means of the levers within his reach.

The Localization of Industries.—The division of labour makes possible the *localization of industries* in the spots where they have the greatest relative advantages. In the days of unspecialized labour, each man was his own food producer, builder, and small arms manufacturer; and such work had to be done everywhere irrespective of inconveniences and absence of facilities. But division of labour combined with good means of transport has made Lancashire the seat of the textile industries, Staffordshire of the potteries, the Clyde and the Tyne of shipbuilding. Each important industry has its location.

The particular locality in which an industry ultimately settles is the resultant of several attractive forces the relative importance of which depends on circumstances. They are chiefly the presence of power, raw materials, marketing facilities, and the necessary kind of industrial population. When steam took the place of water as the motive power of machinery, the textile factors shifted from the streams to the neighbourhood of coal mines. If electricity were generated on a national scale, we might expect to find our manufactures clustering round the sea-ports: proximity to the sea would become more important than proximity to coal mines. Birmingham became the centre of the brass trades, not because of the presence of raw materials or power, but because the industrial population of Birmingham was already accustomed to similar work on metals other than brass. Other determining forces are climate, and the nature of the soil.

Once industries have been localized they can produce more economically than when they were scattered. Subsidiary industries, for supplying them with machinery, etc., spring up in the same neighbourhood; railway companies accommodate them with good means of transport, and special freight rates; markets for

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the raw materials of the industries and for their finished products develop in the locality. And the whole economic life of the community adjusts itself to the circumstances and comes to look to the locality rather than elsewhere for the goods in which it specializes.

The *international division of labour* carries the same principle one step further, and the advantages of specialization by countries in those forms of industry for which they have the greatest relative advantages are similar in kind. That England should specialize in manufactures and the Argentine in agriculture is, from the point of view of wealth production, of unquestionable advantage to each, and to the world. Each country can thus obtain, by exchange, goods which it could not itself produce at all, or which it could produce only at much greater cost: and the total volume of wealth is increased. Objections to such division of labour are based not on economic considerations, but on considerations of national security; and where nations have artificially fostered industries for which they are not by nature suited, it has been in preparation for the contingency of war.

It should be noted that here, as in the case of division of labour between individuals, the best division of effort will be that in which each country specializes, not necessarily in the industry for which it is best fitted absolutely, but in which, considering all the circumstances, it has the greatest relative advantages.

Division of Labour and Large Scale Production

The division of labour, the introduction of machinery and the localization of industries, lead to the growth of large scale industries, which are the mark of modern production. We find them chiefly in the manufacturing industries which work on great masses of homogeneous material—in iron and steel works and food production; but they are also common in mining, banking, and the work of wholesale and retail distribution; and even agriculture, in England, has been carried on on a large

scale since the enclosure of lands and the introduction of scientific methods.

The advantages of large scale production may be considered from two sides—from the side of marketing, and from the side of manufacturing.

(a) The big business is obviously at an advantage in buying and selling. It buys in large quantities and therefore economically—whether raw material or machinery. It distributes its commodities in large quantities, and can save costs of transport by having railway sidings, engines, and wagons of its own. It can have numerous travellers, pressing the merits of its goods on the attention of customers, and it can afford to carry on extensive advertisement. These means are impossible to a small firm which, however good the qualities of its products, is unable to get them so prominently before the eyes of the public.

(b) In the actual processes of manufacture the savings due to division of labour can be fully used. Men can be put on the jobs for which they are best fitted. Machinery of the best kind can be utilized to the full, as it could not be in a small business. The arrangement of the factory can be such as to save waste of time in passing goods from one department to another. Waste products can be fully utilized. Moreover, the large business can introduce within its own walls various subsidiary industries. A large cocoa works, for instance, makes its own chocolate boxes and cocoa tins, does its own printing, and turns out its own show-cases.

All these advantages, profitable to the owners of the business, also result in an increase of the volume of production relatively to cost. For in all businesses certain running charges are being incurred all the time, irrespective of the amount of produce being turned out. Obviously, then, the greater the volume of output, the smaller the share of general expenses each unit has to bear.

Increasing and Diminishing Returns.—In discussing

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the productivity of land, we have already referred to the conception that there is in agriculture a tendency to diminishing returns: we have seen that, apart from improvements in methods of farming, the returns to additional applications of labour and capital tend, beyond a certain point, to diminish. Now, in manufacturing industries the opposite tendency has been said to hold; and the law of increasing returns is stated thus: that in manufactures, the returns to additional applications of labour and capital tend to increase.

The suggestion therefore is that there is one law for agriculture and another law for manufactures. But there is little real ground for making this abrupt division. In both, under certain circumstances, production will be high relatively to costs, and in other circumstances low relatively to costs. There are not two laws—of diminishing and increasing returns—but one law which operates invariably whether the industry is farming or manufacturing. That law may be conveniently termed, in the language of Gide, the law of "non-proportional returns," and it amounts to this, that there is a point up to which every increase in the application of labour and capital, whether in farming or in manufactures, is rewarded by a more than proportional return in the shape of produce; and that beyond that point, every additional application yields a less than proportional return. And the condition determining whether the return is to be greater or smaller is the productive efficiency not merely of each factor taken by itself, but of the factors in combination. We have already seen that labour with too little capital cannot attain its greatest efficiency; and there is, in each stage of industry, a certain combination of the factors of production which will yield the best result. Now in manufactures all these factors of production are more or less in the control of the employer, who can vary them at will; and can therefore keep his business at its point of maximum efficiency. But in agriculture one factor is

limited, namely land ; the farmer has to make the best of the land at his disposal, and therefore, apart from improvements in method, he cannot add to his labour or capital on a given piece of land, without suffering a diminution in the returns to the extra capital and labour.

Division of Labour and Mobility

The specialization of labour leads to the erection of barriers between occupations, whether on the same level or on different levels. A navvy cannot easily become a clerk, nor a pattern-maker a shipping magnate. Such movement or transference from one occupation to another is one instance of *mobility*, which, in its other aspects, will be discussed in Chapter XII. It need only be mentioned here, that a limited development of specialization tends to fix men in certain trades from which they cannot escape ; but division of labour, more fully developed, helps to make the transference easier. Thus, when each man learned a skilled trade, the difference between one trade and another was so great that to cross from one to another was almost impossible. But minute subdivision of occupations results in similar operations being common to many industries ; and enables a man to enter another industry in case of the failure of his own. And if production is to be maintained at its maximum, mobility should be as perfect as possible. It is only thus that changing demand can be met by a change in the supply of relative kinds of labour.

Limits to the Division of Labour

There are two limits to the indefinite extension of the principle of division of labour : one set by economic considerations, one by consideration of the human factor, labour.

(a) Division of labour is first limited by the extent of the market. If every village were a closed system, division of labour would not be carried very far. Re-

sources would be insufficient to permit every man to specialize ; and the products turned out too few to permit of much exchange. With every extension of the market, these disabilities are gradually removed, till with the modern world-wide market, each man need only fill a small niche in the fabric of production.

(b) The second consideration is the nature of the human being in whom labour is embodied. Our knowledge of the nervous system is yet too scanty to permit of dogmatic assertions ; but recent researches tend to show that beyond a certain point, increased division of labour being accompanied by the monotony of repetition movements, leads to rapid fatigue of the nerves and brain centres ; and that this result is reached frequently long before any feeling of muscular fatigue is experienced by the worker himself. It has its result, however, in reduced output, so great that a change in occupation would be advantageous even from the point of view of maximum production.

Even more important is the fact that there is a point beyond which the human being will revolt against the increasing monotony of work, and will demand that the question of maximum output give way to that of the well-being of the man.

Such considerations suggest the evils of specialization. Unregulated by reference to the social good, specialization contributed to the elimination of the craftsman, to the misery of the industrial city, and to that cleavage between labour and capital which it is the difficult task of the present age to overcome. Specialization must be controlled by reference to ends which are human.

CHAPTER III CAPITAL

Aids to Production

HERE is a great difference between the primitive boat-builder and the worker in a modern ship-yard. It is not only that the modern worker has been trained for a particular occupation, whereas the primitive man was boat-builder one day and hunter the next, but that he uses costly machinery and appliances to help him in his work. The primitive man had no such conveniences. An axe or a roughly made knife were his sole tools.

It is a far cry from the simple tool, like the axe or the knife, to the elaborate machinery used in modern production; and it is the growth of machinery, buildings, railroads, cranes, steam-hammers, etc., which has given its special character to modern industry. Nevertheless they belong to the same class of goods. Both perform the same function in industry—they act as aids to labour, and without them work would be crude and unproductive. Both come into existence in the same way: they are the saved up products of labour. They are pieces of wealth put into a shape in which they are of use not for consumption, but only to help in further production.

What Capital is

Many different kinds of things perform this function of making possible further production. All tools and machinery; the buildings, factories, warehouses, and mines in which work is carried on; the materials out

of which things are made; the stocks of completed or half-completed articles in the store of the wholesale merchant or the shop of the retailer; the money and bank "credit" out of which the employer advances wages to his workers before he has sold the product of their labour—all these are necessary in order that modern production may be carried on.

Now, to anything which performs this function, the economist applies the name Capital. Whether the thing is elaborate or simple, costly or cheap, owned by private individuals or belonging to the community as a whole, makes no difference: from the point of view of the production of wealth, all such things perform a function which is not performed by labour or land: they all therefore belong to one category, capital, and take an important place as one of the agents of Production.

But there are other ways in which we may look at these pieces of wealth. We may for instance, as owners of capital, ignore the function they perform in industry, and think of them only as a source of income to ourselves. We may even forget that they exist in the definite shape of a machine, or a mile of rails, and think of them only as a vague power, or as so much money in the bank yielding interest, or as shares in a company. From the point of view of the individual, then, capital is a source of revenue.

There is still a third way in which capital may be regarded. We may direct attention to the fact that in the last hundred years capital has come to hold a unique place in industry. In place of consisting merely in a number of small tools which any man could own and use as a worker, it has come to consist in large and costly machines which only the rich can possess, but which, nevertheless, every man must have access to if he is to take part in production. We may hold, therefore, that the possession of such things gives to their owner, the "capitalist," a power over the lives of those who do

not possess them, inasmuch as he can dictate the terms on which he will allow them to work. The existence of costly pieces of capital in the hands of private individuals splits society into two classes—the capitalists and the wage-earners, and gives its special character to the present industrial system. This is the view developed by Karl Marx, the German socialist, in his book "Das Kapital," published in 1889. Capital for him then is a "historical category." That is, it is the mark of a particular stage of social development; and its significance lies in the double fact that it is essential to industry and that it is the private property of individuals.

These three views of capital are views of the same thing seen from different angles. In the first case it is looked at with reference to the production of wealth in general; in the second, with reference to its effect on the wealth of individuals; and in the third, with reference to the structure of modern economic life. In this chapter we shall deal with it chiefly from the first point of view.

In what things Capital consists

All capital is wealth, but not all wealth is capital. At any particular moment a definite set of things is actually being used as capital. But we cannot arrange actual objects on two sides of a line and say that everything on one side is capital and everything on the other side is not capital. Most things could be used as aids to production; and many things originally intended simply to satisfy wants, become capital through force of circumstances. During the war, privately owned motor-cars used for pleasure were requisitioned by the Government and given over for the use of munition factories. They passed in a moment from consumption-goods to production-goods. Thus the distinction between capital and not-capital does not lie in the nature of the article, but in the use to which it is put.

Now the income of an individual is a claim to a certain

amount of wealth. He can, if he likes, use that claim to purchase articles for his immediate gratification. That is, he may use it in consumption. Or he may refrain from using part of it thus, and lend his claim to a Company which will purchase with it materials for use in industry. In this case the individual has saved part of his income and it has become capital.

Thus, whether we look at Capital as consisting in material things, or as consisting in a claim to material things, its distinctive characteristic is that it is used in a particular way—namely to aid further production.

The Growth of Capital

When a man refrains from using any of the wealth he possesses he is said to "save." Before there was any money in existence, saving was possible only on a very limited scale; for few things are capable of accumulation without deteriorating. When money became common, a man could save some of his money, which continued to exist as a claim to wealth. Before the days of banks such savings were kept in a drawer or a stocking; and so long as they remained there they were of no use to any one. But in modern times, savings are not idle wealth; they are lent by banks to people who want them for production; and the prosperity of a country's industry depends largely on the degree to which such capital has been accumulated, and can be made available for production.

The general condition of the growth of capital is that production should exceed consumption: that involves two things—(a) first, that the amount of wealth produced should exceed the minimum necessary for the sustenance of the people; and (b) secondly, people should be willing to save part or whole of the surplus. The size of income relatively to needs determines the ability to save. The will to save depends on other considerations. For the man with a limited income and large family claims, the

act of saving means the exercise of considerable restraint and foresight. So long as any felt need is not met, an effort is required to postpone a present for a future satisfaction. Among the mass of the people, therefore, whose incomes yield little surplus over necessities, the willingness to save will depend on several factors. (a) They must possess those qualities covered by the term "thrift." (b) There must be security of property, whether against foreign enemies, or against lawless individuals, or against a rapacious or ill-advised government, or an unstable economic system. Few men will refrain from consuming their wealth immediately, if their savings are likely to be stolen or destroyed. (c) Thirdly, capital is more likely to accumulate and to be made available for industry, if well-established institutions exist, not only making accumulations safe, but offering remuneration for their use. That the offer of interest on capital increases capital, there can be little doubt; but the relative effects of a high or a low rate of interest are more difficult to estimate. For this purpose we must distinguish the different motives to saving. These are mainly three—first, saving with the intention of laying by sufficient to yield a certain income in old age; second, saving in the hope of becoming rich and leaving as much as possible for one's family; and third, saving for the ordinary purposes of business extension. In the first case, the amount saved will obviously depend on the rate of interest: with a high rate of interest less will have to be saved than with a low rate. But, saving on either of the other motives is unaffected by rates of interest. It should be noticed that the question here is between saving and spending. As between putting one's savings in one industry or another, rate of interest is of course a vital determining factor. Much of the capital in existence to-day is due to the savings of men whose incomes are so large that they cannot spend them, and whose accumulation goes on automatically. They suffer no privation in refraining

from spending, and no moral colour should be given to their act of saving.

Effects of the Use of Capital in Production

(a) If we take the case of agriculture we see that the farmer, who employs labour, must pay his labourers their wages for the work they do in the spring and summer although he will be unable to sell the product of their labour till the winter: without a store of wealth he could not do so. It is out of his capital that their wages are advanced. In the eighteenth century, when agriculture was the main work of western European countries, this was the function of capital to which attention was chiefly directed. When manufacturing industries developed in England during the Industrial Revolution this conception of capital was carried forward from agriculture into manufactures, and emphasis was laid on capital as a fund from which the wages of labour were paid. It enabled the employer to bridge the expanse of time between the beginning and the end of production. With the modern expansion of industries into large scale businesses this same conception was extended. Capital makes possible the "round-about" methods which result in the reproduction of numberless copies of an article. Moreover in the shape of railways, ships, telephones, telegraphs, it bridges not only time but space. And while its first effect is to postpone satisfaction of wants, its ultimate effect is to make more abundant satisfaction possible. Thus, if we had to go to a spring to fetch all our water, we might be able to meet our needs directly, but at considerable trouble. When a city determines to have a water-supply, it has first to dam a lake, to lay miles of mains, to procure reservoirs and cisterns and fit up each house with the necessary pipes. But once this work has been done, abundant water is available at the trouble of turning on a tap.

(b) In the second place, the existence of capital in the

form of tools, machinery, etc., obviously makes nature more productive. This needs no elaboration.

(c) In the third place, the possession of large amounts of capital makes it possible for a business firm to take the risks and make the experiments without which advances in industry are impossible.

CHAPTER IV

THE MECHANISM OF SALE AND PURCHASE

IT has been pointed out that every activity which is required to bring commodities nearer to the consumer or to make them more fit for his use, is correctly termed productive. Among such activities, the buying and selling of goods takes an important place. Every firm and business unit must purchase its raw materials and sell its products, and this work is rightly reckoned as part of its productive effort. And where special agents, merchants, "middlemen" exist, unattached to any industrial firm, and doing nothing else than buying from some people and selling to others, there is no less reason to call their work productive. In the present organization of economic life their work is necessary.

We must therefore examine the work of buying and selling—or exchange, as it is called. But in the present chapter we shall confine ourselves to an account of the means by which this work is carried on. We shall leave to a later section the question of the valuation of goods, which is implied in every act of exchange.

Markets

Exchange implies a market. In early days the market was a place—a square in the village—to which the farmers, graziers, leather-workers, nailers, etc., brought their goods for exchange. The fundamental condition of the market was that within it people were able to choose between the various goods displayed for sale, and

the prices at which they were offered. It was an area within which competition reigned. As means of transport and communication developed, this fundamental condition of the market was attainable over wider areas; to-day the market for some articles is world-wide. This means that circumstances have so changed that people can now discriminate between articles offered for sale without actually seeing all the goods spread out before them, and that for such an article as tea, the buyer is at no more disadvantage if he lives in England, or Russia, or South Africa, than if he lives in Ceylon where the tea is grown.

The evolution of the world-market has had several stages. First, as stated, there is the *local* market, in which the goods are displayed and can be examined and tested and compared. Next, the merchants, instead of bringing the whole of their produce to the market, send *samples*, with statements of prices, and the buyer can judge the quality of the whole from the samples produced. Some articles, of course, do not lend themselves to this method. In the third stage, merchants dispense even with the actual sending of samples, and adopt the method of *grading*. Goods of a certain kind are graded into classes, to each of which a distinctive mark or name is attached; and each buyer and seller knows what the mark means. Not all goods can be so graded, or identified by means of marks; but whenever an article, like tea in its various qualities, can be so classified, it is a great saving of time and expense to adopt this method. Lastly, as soon as the method of grading has become common, things begin to be bought and sold even before they are in existence. A buyer will purchase so much of a certain article of a certain grade, to be delivered at a future date. Such transactions are called "future dealings" or simply "futures." When this stage has been reached the market is widened with respect both to space and to time.

Foreign Trade

The fact that each country has its own metallic currency gives rise to special problems in foreign trade as distinct from home trade. But these are chiefly questions of prices and international values, and will be dealt with in a later chapter. Otherwise there is no difference in kind. In both cases the exchange is between individuals; A in France buys goods from B in England, who sells goods to C in America. In both cases the individual buys where he gets the best article at the cheapest price; and sells where the advantages are greatest. In both cases, ultimately, the seller receives the same kind of payment, although the way that payment reaches him has its peculiarities. There are, of course, differences of degree between home and foreign trade. Distances are sometimes, though not always, greater, and cost of transport is therefore a larger element in the latter case. But it is easier to send goods from France to England (foreign trade) than to send goods from one side of America to the other (home trade).

Barter

In the earliest markets purchase and sale took the shape of barter, or the exchange of goods for goods. Even to-day a boy will "swop" a dozen marbles for a top, and a man will exchange a gramophone for a typewriter. But barter is attended by many inconveniences. To begin with, ordinary commodities are not acceptable under all conditions. A may want to part with his gramophone, but B may prefer the music of his typewriter and refuse to exchange. Secondly, in barter it may prove impossible to bring together exact equivalents of value. The farmer wishing to exchange his cow for a number of small commodities, must either find some one who will supply him with all the things he wants in return for the cow, or else divide his cow into

small portions and perform various acts of exchange with different people.

The Introduction of Money

Under such disabilities men would at first be driven to accept things they did not want, in the hope of being able to exchange them later for articles they required. If some one article began to be used frequently for this purpose, it might develop into a regularly recognized *medium of exchange*. In order to be generally adopted in this way, it would have to be *acceptable* under all conditions among the people who used it. Moreover, the commodity likely to survive as the fittest medium of exchange would be one whose qualities enabled it to overcome other inconveniences of barter. A thing which, in addition to being a good medium, could at the same time be used as a *measure of value*, would be more likely to be adopted than one which could act only in one of these capacities. Anything which acts thus as a medium of exchange and a measure of value is money.

The necessary Qualities of Money

To perform these functions well, money must have certain qualities possessed only by a few rare commodities. It must, as already said, be acceptable. This implies that it must be wanted for its own sake independently of its use as money. It must be *portable*, having much value in little bulk. It must be *divisible*, so that it can be used for payment of small accounts as well as large, and that implies that its value must not be too great for its bulk, and that it does not lose value on being divided. It must be *imperishable*, for no one would accept it if he felt that he could not use it later in payment for goods. It must be *uniform* in quality so that it is of equal value weight for weight, and it must be *difficult to counterfeit*, for where spurious money is not distinguishable from good money, suspicion will fall on both.

Metallic Currency

It is because the precious metals best satisfy these various requirements that they have in most countries tended to survive out of a large number of commodities used as money at different times, and including such various articles as pieces of leather, beads, cattle, and even slaves. And of the precious metals gold is probably the most satisfactory of all. But silver also occupies an honourable place. In this country till 1816, and in France and the United States till now, there has existed a *bimetallic* system of currency in which both gold and silver hold an equal place. In this country, while silver coins are used, they are subordinate to gold. Silver was "demonetized" in 1816, and gold is our sole standard money.

The facts of our currency can be briefly stated. At first all money was weighed, and a "pound" was a pound weight of silver. "Coinage" was introduced to lessen difficulties in the use of the metal: the shape of the coin and the stamp on its face are only guarantees that the value of the coin is what it pretends to be. This coining is done by the Government, and many governments make a charge, called *brassage*, for turning gold bullion into coins. But in England no charge is made. An ounce of gold (eleven-twelfths fine) is turned into $3\frac{1}{4}$ sovereigns; and anyone taking an ounce of gold to the mint (which is a government monopoly) will receive $3\frac{1}{4}$ sovereigns, or £3, 17s. 10 $\frac{1}{2}$ d. for it. Actually, however, gold bullion is always taken to the Bank of England, which gives for it £3, 17s. 9d. per ounce. In addition to making a charge for coinage, some governments put into a coin a smaller value of metal than the face value of the coin. The difference is called *seignorage*. There is no seignorage on our gold sovereign, but there is on our silver coins. Money may further suffer *debasement*, either through deliberate action or by ordinary wear and tear. Deliberate de-

basement, once the sport of kings, is now practised only by rogues of lower estate. The hardened edge of our more valuable coins makes difficult the extraction of precious metal and the substitution of a baser one. A check in the debasement due to wear and tear is provided by the automatic rejection of the "light" sovereign when it passes through the Bank of England.

Gold, then, is our standard money. It is *legal tender* to any amount, and a creditor is by law required to accept it in payment of any debt. But alongside of gold we have silver and copper coins, which pass from hand to hand quite readily, but which are not standard money. Their currency value is greater than their metallic value, and by themselves they would be an unsatisfactory form of money. But they are useful for small payments, and there is no danger in their use, since their currency value is maintained at a definite ratio to the standard money, through the limitation of the supply of them by the Government, which has a monopoly of their issue. The withdrawal of gold from circulation during the war period does not make this description inapplicable to that period. It is because gold is our standard money that people in a crisis rush to withdraw their gold from the banks. Government made it difficult of access in order to maintain the bank reserves which, as we shall see, are necessary.

Paper Currency

With a metallic currency alone a country could carry on its exchange, though it might be put to many inconveniences. But gold is scarce and difficult to procure, and any device to economize the precious metal while allowing its functions to be performed, will be welcomed. In different countries there exist various substitutes of this kind, like bank-notes and Treasury notes in England, and bullion certificates in America.

Paper of this kind is currency just as much as gold or silver. That is, it "runs"; it circulates freely from

hand to hand. In this it is to be distinguished from cheques which do not circulate freely, but are taken to the bank. But while bank-notes are currency, they are not money. Money, as we have seen, is acceptable as a commodity apart from the money-function that it performs. Bank-notes are not acceptable apart from one of two conditions: either, that they are promises to pay their face value in gold, and that these promises can be redeemed at any time; or, that they are backed by the sanction of a government universally recognized as stable. In either case they do not stand on their own feet; it is only because of what supports them that they are accepted at all.

There are three main types of paper currency. The first is *convertible paper*. As a piece of paper it is valueless; but it can be turned into gold on being presented at a bank. To this type belongs the English pre-war bank-note issued in various denominations from five pounds to a hundred. (The Treasury note is theoretically convertible on being presented at the Bank of England.) Since anyone can have gold for the bank-note when he wants it, the banks must keep a reserve of gold to meet such demands. The nature of this reserve, and the degree to which the bank-note means an economy in metal, will be considered later.

A second type of paper currency is the *bullion certificate*, which is issued against a cent per cent reserve; the only economy in the precious metals which it effects, therefore, is the saving in wear and tear. To this class belong the United States gold and silver certificates.

Thirdly, there is *inconvertible paper*, which becomes currency on the decree of a government. It carries no promise to pay in gold. Consequently it involves no reserve, and is simply additional currency in the form of paper. It means, therefore, a great economy in the metals and it is sometimes resorted to by governments in times of financial difficulty. But its use is attended by grave risks. There is a danger that governments

will be tempted to issue it in excess of requirements. Again, while a government can force it into circulation, it cannot enforce its acceptance at its face value; and any suspicion of the stability of the government will lead to its "depreciation." Finally, while such currency may pass readily in the country of its issue, it is of no use in international trade.

The above forms of paper currency are issued by governments or banks, whose position is normally so secure that little faith, or "credit," is necessary on the part of the public using the paper. But certain other paper instruments, performing some of the functions of money, are in use, which issue from individuals, and whose acceptance involves a considerable element of credit. Of these, the most important types are the cheque and the bill of exchange.

The *cheque* has established itself in England as a common medium for the payment of internal debts. It is an order, written by a private individual, instructing a bank to pay the bearer a sum of money stated on the cheque. It is more convenient than the bank-note, since it can be made out to any odd amount of shillings and pence; and if "crossed" it is safe, since it can then be cashed only by an individual who himself has a banking account.

The *bill of exchange* is the most convenient instrument for commercial transactions, especially those between individuals living in different countries. In the matter of payment two difficulties must be overcome in the case of foreign trade: the first arising from the fact that the currency and banking system of each country is peculiar to itself; and the second from the time that must elapse between the dispatch of goods from one country and their receipt in another. The bill of exchange meets both these difficulties. How, we shall see in a moment.

The bank-note, the cheque, and the bill of exchange are the chief instruments for economizing in the use

of the precious metals; and the economy is effected through the agency of banks and other financial institutions.

The Function of Banks

The function of banks to which we shall direct attention is this work of economizing in gold through their methods of issuing or handling bank-notes and credit instruments. In normal times such paper will be used freely in commerce only so long as people believe that they can get gold sovereigns for it on demand. The function of the banks, therefore, involves a problem—how to economize in gold and at the same time have gold available for everyone who wants it. We shall examine this problem in relation to bank-notes, cheques, and bills of exchange.

(a) Ignoring for the moment the peculiar war-time condition of a Treasury note issue, the Bank of England has a practical monopoly of the issue of bank-notes in England. It did not always have this monopoly. The goldsmiths, who were the earliest bankers, undertook the safe-keeping of people's savings, and issued to the depositor a receipt for the money they deposited. This receipt was the earliest form of bank-note; and where the goldsmith was well known, the receipt was used by merchants in commercial transactions. The goldsmiths thus finding that much money lay idle in their strong-boxes, conceived the idea of lending some of this money to others; and so long as they kept a sufficient reserve for the demands of those depositors who might want their gold, they were safe. But some early banks overstepped the limit of security and involved themselves and others in disaster. Consequently the right to issue notes came to be practically confined to the Bank of England, and in 1844 there was passed the Bank Charter Act, which established a relation between the bank-notes in circulation and the amount of gold that had to be kept in the bank. On

the basis of past experience it was decided that it would be quite safe to have £14 millions of bank-notes in circulation uncovered by gold deposits: notes to this value, it was held, would remain in circulation even in the worst times and their holders would not come to the bank and ask gold for them. But any additional note, above this amount, could be issued only if its equivalent in gold was kept in the bank. The £14 millions had been increased before the war to about £18½ millions.

Hence at the present time the use of bank-notes means an economy in gold. But the limit of this economy, namely £18½ millions, is definitely fixed by law, and the banks cannot alter it. The law was virtually suspended in war time through the issue of Treasury notes, which are in practice inconveritible and are not backed by gold.

(b) The use of cheques is not subject to any such legal limitation. Jones, let us say, deposits £1000 in gold in his bank, and can then give cheques on the bank to that amount in the payment of his debts. But the bank need not keep in its coffers any or all of that £1000. It may lend it to manufacturers. It lies with the banker to decide for himself what reserve he shall keep against possible demands.

The economy in gold effected by the use of cheques can best be shown by an illustration. Jones, let us say, has deposited his £1000; Smith £2000. Jones buys merchandise from Smith to the value of £50 and writes a cheque, which is an order to his bank to pay Smith £50. Smith can (if it is not war time) demand this £50 in gold from the bank. More probably, however, he will endorse the cheque, hand it over the counter of the bank, and have £50 credited to his account. The result of the transaction is that Jones' account is reduced to £950 and Smith's increased to £2050. No cash has passed, but the debt has been settled. If Jones and Smith had dealt with different banks the result would

have been the same; and in this way thousands of transactions can take place, and debts be paid, without any passing of gold, and merely by the changing of figures in various bank books. Now all the banks in the country have head offices in London, and the head offices are connected with each other through the "Clearing House," which meets twice daily and at which the claims of different banks are balanced against each other. Thus it may be that the London City and Midland Bank has received cheques from its customers to the value of £50,000 against Lloyd's; but this cash need not be paid over, for Lloyd's likewise holds cheques against the London City and Midland for £45,000. Thus Lloyd's is a debtor to the extent of £5000. Now, since all the banks deal with the Bank of England, not even this £5000 need be paid in cash. Lloyd's will write a cheque for £5000 on the Bank of England in favour of the London City and Midland; and the ultimate result of thousands of acts of buying and selling will simply be the changing of certain figures in the books of the Bank of England.

(c) The use of bills of exchange in foreign trade ✓ obviates the necessity of sending gold across the sea. A in London, for instance, sends goods to the value of £1000 to B in New York. B does not send dollars to A, because they are not English currency, and because the cost of sending them would be great. Instead A "draws" a bill on B, ordering him to pay the amount in three months. He sends this to B, who "accepts" it—that is, writes across it "Accepted"—thereby making himself responsible for paying the sum when the bill falls due. But probably, long before the three months have elapsed, C in New York has sent goods to the value of £1000 to D in London. D therefore has to pay C £1000. A's bill can be used for this purpose. D buys it from A, paying A in English money, and thus satisfying A's claim. D then sends the bill to C, who gets the amount in American money from B. Then

C's claim is satisfied. Both sellers have received their payment and no cash has crossed the sea.

In actual cases, the network of buying and selling is very complicated and a bill may pass from hand to hand and be bought and sold many times, and so settle many debts.

Banks and other financial houses deal in these bills. We imagined in our example that A drew his bill on B, a private merchant. More probably he draws it on an "accepting house," which makes a business of accepting responsibility for payment of bills, in return for a commission from the merchants whom it thus accommodates. When the three months are over, then, the accepting house pays the money.

If in the meantime the holder of a bill wants cash, he takes it to a "discount house," which makes a business of cashing bills immediately, holding them till they fall due, and receiving the full amount from the accepting houses. The discount house pays the holder the amount of the bill, less discount for immediate payment. These discount houses are frequently banks. From the point of view of the banks, bills are "liquid assets" which they can cash within a short period. They are, therefore, useful as an alternative to a cash reserve against demands of depositors.

(d) Banks perform another function which intensifies the "reserve" problem. Up till now we have assumed that the man who draws a cheque on a bank has actually deposited money in the bank. But this is not always so. A man in need of ready cash may ask a bank to credit him with so much; and in return for satisfactory security (in the form of shares, etc.) the bank will comply. Thus the bank creates credit. The man can purchase goods and pay for them by cheques on the bank though there is not a penny of his deposited in the bank. The creation of credit is obviously a convenience for trade; but it intensifies the problem of the reserve.

Thus against the demands of depositors and creditors

the bank must have a reserve; and since that reserve is not legally fixed, the banker must act according to his judgment. But there is an automatic check to a too great depletion of reserves. Every bank has its head office in London, with whom it keeps its reserves. All these head offices keep *their* reserves in the Bank of England. Now the check lies in the Bank of England rate of discount, which is the rate at which the bank will discount bills. If the reserve is being too greatly depleted, the rate of discount is raised. This has the effect of checking the demands for the immediate cashing of bills. If, on the contrary, the reserve is becoming too great, the discount rate is lowered and the opposite tendency sets in.

Thus bank-notes, cheques, and bills of exchange effect an economy in gold; but nevertheless it is clear that it is only because there is gold at the back of all the paper instruments, that the latter can be used at all. *The whole of our credit has a gold basis.* Hence the embargo on the export of gold during the war. In a time of crisis not even a dramatic rise in the bank rate could have the necessary effect of retaining an adequate reserve; and to prevent an undue drain on our gold and the consequent shattering of the foundation of our credit, the Government was driven to its extreme course.

CHAPTER V

ORGANIZATION AND ENTERPRISE

The Need for Organization

THE division of labour, and the use of capital in industry, lead, as we have seen, to improved production; but they divide consumer from producer, and one producer from another. The man who has specialized as a shipwright knows his "job"; but he has probably learned no other kind of industrial work. He knows nothing of selling the produce of his labour; he knows nothing of the other processes involved in shipbuilding; he could not find capital if he wanted it. In short, he could not organize the work of shipbuilding. The development of production has isolated the producing factors from each other. So divided, they would be absolutely useless unless some person or group of persons existed whose function it was to re-unite the isolated units and set each to his task. Who performs this function, and how it is done, is the subject of this chapter.

The Work of Organization

The work of organization consists of two main parts.

(a) First there is organization within a particular business unit—a manufacturing firm or company, a farm or a mine, a bank or a retail store. Every such unit requires labour, capital, raw materials, land: and having acquired these, each in its right kind and quantity, it must co-ordinate them, give each its work, supervise them, decide on methods of division of labour

and methods of payment, on the arrangement of the factory or mine, and so on.

(b) In the second place, just as individual workers and pieces of capital are useless when isolated, and must be organized, so separate firms and separate industries are useless apart from their relation to other firms and industries and to the consumer. Somehow, they must be organized and given their special work. They must know what is demanded, and how much is being supplied by other firms. And some one must exist to give this information.

Common to both of these aspects of the work is the fact that all organization has to anticipate. The organizer must look to possible future developments of his industry and possible future movements of demand, and act according to his anticipations: and since there is always an element of uncertainty about the future, such work involves the taking of risks. This part of the work of organization is called enterprise.

Our question is—Who undertakes the work of organization and enterprise?

In so far as the organizer is a person, he has evolved in the same way as any other specialized worker—a pattern-maker, or a shipwright, or a proof-reader. He is a product of the division of labour and is himself a specialized worker. It is his business to understand his own style of industry in all its main aspects: he should have a knowledge of market conditions: he should understand the financial side of industry: he should, in the words of Carnegie's epitaph, know "how to choose as his servants better men than himself": he should know the problems of labour and the psychology of the worker; and he should be able to co-ordinate the factors of production so as to bring about the best results.

Now if the specialization of the organizer had already undergone complete development one would expect to find the organization of industry undertaken by men

specially trained and fitted for that work, and doing nothing else : and in some types of business, this extreme specialization has actually taken place. But this is not the case universally, and it will be convenient at this stage to look at the various types of business unit, and see how the work of organization is carried on in each.

The One-Man Business

It is the rule in the professions, and still common in ordinary industry, to find a single man running a complete business by himself. He finds the capital, performs the labour, rents the buildings, organizes the work, buys raw materials, and sells the finished product to the ultimate consumer. There is here no specialization. One man takes all the risks, and is at once labourer, capitalist, and organizer.

The Small Private Firm

Throughout the nineteenth century the most common type of business was that of the private firm in which the "employer" provided the necessary capital, did his own marketing, and took whatever risks the enterprise involved. Only the actual labour was performed by workers whom he hired and paid. In this type we have the first degree of specialization. The employer is risk-taker, organizer, and capitalist ; but he is no longer also labourer.

In spite of the rapid development of the large scale industry, and the new types of organization, the small private firm still continues to hold an important place. As against the large scale business, the small firm has certain advantages. The whole work is under the eye of the single employer, who does not require to delegate supervision to others. The small business avoids the danger of routine and red-tape to which the large business is apt to fall a victim ; and wherever articles must be made to suit individual requirements, or to meet in-

dividual taste, the small business is the only possible firm. The city of Birmingham, in spite of the development of large engineering firms and motor-works, is still a city of small industries, for the jewellery articles in which it specializes demand individual treatment and cannot be turned out in bulk.

Similarly, as against the newer forms of organization, like the company, the private firm continues to hold a place in industry, because, even in business, the making of profits is not man's sole interest. The pride of possession and the feeling of power and responsibility are still potent forces in preserving the older type of concern. Moreover, the fear of failure prevents the servant of the company from undertaking risks and enterprises which he would be willing to undertake if he were sole owner, responsible only to himself if he failed and reaping the whole benefit if he succeeded.

The Company

But for some kinds of undertaking the company form of organization is better adapted to modern needs. In this type we find specialization carried one step farther. One group of people, the shareholders, supply the capital and take the risks of the enterprise, and make themselves responsible for this and for nothing else. The general policy of the concern is worked out by a committee, but the actual work of organization and management, which in the private firm is done by the employer, is here carried out by officials and managers and foremen, paid not in profits, but by fixed salaries.

Thus we have in the company a separation of the ownership from the management of the business, a separation which carries with it certain advantages and certain disadvantages. The chief advantage lies in the larger supply of capital which a body of shareholders can command, and which enables the company form of organization to undertake schemes which the private firm could not contemplate. This aspect of the question

became more important through the development of the company idea along two lines:—

(a) Since 1862, when the principle of limited liability was made the basis of company organization, the company has become more attractive to investors of all sizes. Under "limited liability" the liability of each shareholder for the debts of the company is limited to the amount of the share he holds in it; and the Limited Liability Company has thus become the means of attracting into industry the small savings of many scattered individuals who would not otherwise have contributed capital to production at all.

(b) Again, the development of different classes of shares in the company has attracted shareholders of different temperaments and means. Shares may now be "ordinary," "debenture," or "preference." The holders of "ordinary" shares are responsible for the policy of the company, and they consequently reap the profits which are the reward of success, or suffer the losses which are the penalties of failure. The holders of "debenture" shares simply lend so much capital to the company at a fixed rate of interest, which must be paid to them (on the security of the property of the company) before any profits are paid to the ordinary shareholders. "Preference" shares vary in character; normally they lie between debenture and ordinary shares: their holders receive a fixed rate of interest (higher than that in debentures) which must be paid before ordinary shareholders receive a dividend, but which ranks after debentures.

On the other hand, the separation of ownership from control brings disadvantages with it. The user of the capital—the manager—may err by excess or defect. Since the capital is not his, he may be less careful in its use than the private capitalist-employer; on the contrary, being subject to a committee or board, he may pursue less bold courses than he would willingly undertake were the risk entirely his own. But

perhaps the most fundamental objection to the company idea lies in its dissociation of service from income. It removes from those who get their dividends from business all responsibility for the way in which business is carried on, and the conditions under which labour is employed. They delegate their human and social responsibilities to paid servants.

Combination

The above forms of organization may act under intense competition, which leads to low prices. Where possible, therefore, such rival concerns frequently combine to keep up prices. In its most elementary form such combination may take the form of a price-agreement, each firm agreeing not to sell under a certain price. This may develop into a selling association, in which each concern sells all its output to a central agency which sells to the public; and this may be accompanied by a restriction on the output of each firm. The temptation to rival firms to undercut each other leads to the failure of such selling associations, except where (as in Germany) a price agreement can be enforced at law, and where therefore the association has redress against a recalcitrant member. Thus this form of combination is commonest in Germany, where it is called a Kartel.

Elsewhere the Kartel either breaks down altogether or it becomes a more complete combination. The most developed form of combination is the Trust, under which all the conditions of production as well as marketing are unified. A Trust can succeed best where potential rivals are few and where great economies arise from large-scale production, possible only with a large capital. A Trust for the manufacture of carpet tacks would have little likelihood of permanence. The success of trusts in protected countries is due to the exclusion of possible foreign competitors.

The limiting case of combination is *monopoly*. It

exists (if at all) where the combination has complete control of the conditions of supply. Such is seldom possible in the case of ordinary commodities where potential rivals must always be reckoned with; and it occurs chiefly in the case of those goods and services which can be supplied only by a single firm in any one market. Examples of such goods and services are the gas and water supplies of municipalities. Supplies of this kind are usually undertaken by local authorities, and will be considered later.

Co-operation

The co-operative form of organization takes many shapes. In England the best known is the Co-operative Store, which is based on the co-operation of individuals as consumers to buy goods. In the store the capital is subscribed by its members, and the bulk of the profits are distributed to members in proportion to their purchases. The development of the movement led to its extension backward to earlier stages of production—to wholesale business and to manufacturing and agriculture. The wholesale society is to the retail store, as the retail store is to the individual member. The retail stores supply the capital of the wholesale society and draw from it dividends in proportion to their purchases from it. The "productive" departments are, however, carried on in the same way as ordinary private firms. The retail store benefits from the more or less constant demand of a regular clientele; and from the avoidance of over-capitalization due to its method of adding to its capital, under which additions to capital bring with them additions to membership.

Other forms of co-operation are built round other interests of individuals. Agricultural co-operation unites independent farmers for the purchase and sale of materials and produce; co-operative credit societies enable small farmers or artisans to get capital on personal rather than material security; and productive co-

operation is the co-operation of workers, who unite to provide their own capital, labour, and organization, without the intervention of the private capitalist or employer.

Enough has now been said to show that within the business unit, the work of organization is carried on by people more or less specialized for the work, and whether the actual organizer is the private capitalist-employer, or the paid official of a company or government undertakings, his work is the same, and the qualities he must possess are similar. He must have an all-round knowledge of the industry in which he is engaged; he must know human nature, and he must be alert and resourceful and rapid in judgment.

As between different firms, either in the same or in different industries, the work of organization or coordination is carried on by the same groups of men. Each firm must find its place in the industrial world: it must keep in touch with demand: it must know the best sources of the materials it requires: it must be linked up with industries and firms both higher and lower in the stages of production than itself. The men who do this linking up are organizers. Again, the work is sometimes done by the private employer himself. Or, in larger businesses, special buyers are employed to attend entirely to the purchase of materials, etc.; and they form the link between their firm and others. Or, again, special agents, merchants, or middlemen may exist, independent of any single industrial firm. They buy from one and sell to another, and thus carry to different firms and industries the necessary information as to the course of demand and supply. Such agents exist as intermediaries after every stage in production, till ultimately the article comes into the hands of the "retailer" who is the last "middleman" bridging the gap between the producer and the consumer.

PART II

THE WEALTH OF THE INDIVIDUAL:
EARNING AND SPENDING

CHAPTER VI

THE PROBLEM OF DISTRIBUTION

CRITICISMS of the existing system of industry are directed in the main against the distribution of wealth in which it results. It is called a "bad" or an "inequitable" distribution, and the facts of the co-existence of great poverty and great wealth are cited in support of its condemnation. In particular the critic asks two questions: (a) Why are different kinds of services so unequally rewarded? Why, for instance, does George Robey, pretending to be a policeman, earn £500 a week (if he does) while the real policeman earns less than half of that in a year? (b) Secondly, what determines the aggregate shares of the national income that go respectively to capital as a whole and to labour as a whole?

Our business in this book is not primarily either to justify or to condemn this distribution; but to explain how it comes about.

Criticisms like the above involve at least two distinct economic questions. We shall deal with them in their proper sequence; but meanwhile we must be sure of the nature of the problem we are seeking to solve.

What is "Distributed" "

The national income was valued (in 1911) at £2100 millions. But this figure is only a shorthand way of describing a complex group of things which could not be described in words or even visualized. It is not the value of all the wealth that existed in the country during the year 1911, but only of the net new wealth that was produced during that period. There is a constantly flowing stream of goods and services issuing from factories and mines and from the labour of all kinds of people, and forming the gross income of the country. In the process of its production certain capital wealth is worn out, and before we arrive at the net income for any period, we have to allow for the wear and tear of machinery and other capital used in production. What remains is the net income, and it is this—a sum of concrete things and services—which was valued, for the year 1911, at £2100 millions; and it is this that is "distributed."

But this total year's income did not exist all together at any one time. Its items are not all of them susceptible of accumulation. They came into existence in the year; but many of them passed out of existence again before the year was out.

How Distribution takes place

These pieces of wealth making up the national income get into the hands of individuals, day by day, and week by week; and by these individuals they are either consumed or saved. If saved, they become new capital and help to carry on the continuous work of production and to issue in new income. If consumed, they are used-up, in the form of food, clothing, furniture, light, heat, etc. That is to say, the individuals who have helped to produce the nation's income, consume it. But they do not consume the actual things they have produced. What the individuals get is a general claim,

of a certain amount, on this miscellaneous wealth. They get, out of the £200 millions, so many pounds a year, or shillings a week. They draw these claims in the shape of wages, interest, profits, or rents, day by day; and day by day they exchange them for the concrete goods which they really want.

The Shares reaching Individuals

Our problem then is to find what determines the shares of the national income that reach the individuals. Let us remind ourselves of a few elementary facts. The total income is not, of course, poured into a common purse, and then shared out among individuals either equally, or according to their needs, or according to their deserts. To divide it up in any of these ways, we should require a Ministry of Distribution, which, on any of these principles, would have its work cut out for it. Pure equality would probably be the simplest principle. If it attempted to pay people according to their needs, it would find considerable difficulty in measuring their needs. It might indeed attempt to provide for each a minimum sufficient to cover bare physical wants: as is attempted to some degree in several developed states by means of Poor Laws, Insurance Acts, and Minimum Wage Legislation. But above that physical minimum it would meet with insuperable difficulties. Nor would it find the problem easier if it tried to reward people according to their deserts. Under no system could the individuals who were most deserving in the moral sense be rewarded by the largest share in the economic product.

But we have no superman or Minister of Distribution, dividing out the national income. And indeed we shall look in vain for the principles of distribution so long as we fix our attention on the individual. For it is not individuals as such who are paid out of the national income. Individuals receive payment only in virtue of their service as labourers, or in virtue of their possession

of property which is useful in production. That is to say, it is factors of production—land, labour, capital, organizing power—that are rewarded; and individuals get a small or a large share, are rich or are poor, only through their happening to command certain amounts and certain qualities of labour or property.

We can therefore dismiss the case of the individual at once, by saying that the share of the national income that reaches him depends on two things: (a) the amount and kind of service he gives in the production of wealth; and (b) the amount and kind of property he owns and permits to be used in production. The great inequalities in the incomes of individuals follow from the fact of private property, the justification of which is a matter, not of economics, but of social philosophy. In this economic inquiry, therefore, we must shift our centre of interest henceforth from the individual to these two things—labour and property.

The Economic Problems of Distribution

Our question then relates to the remuneration paid to the various factors of production—to labour (including organizing, managing and professional work, as well as wage-earning labour) and to property (including capital and land). And we must keep separate two distinct aspects of the problem. We have to explain in the first place the different rates of remuneration received for services—different rates of wages received by different workers and in different occupations: different rates of interest for different units of capital: and different rents for different acres of land. In the second place, ignoring these relative rates of remuneration, we have to ask broadly why property as a whole receives (in the shape of interest and rent) a certain share of the national income and why labour, as a whole, receives a certain share (in the shape of wages and salaries). Let us look at the common factors underlying both these problems.

Value and Distribution

In a system of industry based on private property and freedom of enterprise, the factors of production are employed and remunerated by organizers or entrepreneurs. The entrepreneur pays wages for labour, interest for capital, and so on, because these factors are valuable to him and because without payment they would not be forthcoming. It is for the same reason that people have to pay a price for ordinary commodities, like soap and sugar: and it would seem therefore that the problem of distribution is just part of the problem of value: that if we explain what forces determine the value of commodities, we have thereby explained the value of the factors of production, and that nothing else is required for an explanation of wages, interest, rent, and profits.

Now it is true that in discussing the problem of the value of commodities in exchange (which we shall do in the next two chapters), we shall arrive at conclusions applicable to the factors of production. The problem of distribution is part of the problem of value. But in the case of the factors of production, the problem takes on a different aspect, for reasons which we shall now enumerate.

(a) The factors of production have value as such only because the commodities which they help to produce have value: their value is derived from that of commodities. But we cannot collect together all the commodities produced by any one factor of production, add together their values, and say that is the value of the factor. That is impossible, because different factors co-operate in production, and their respective contributions to the finished commodities cannot be separated out from each other. Hence the connexion between the value of commodities and the remuneration of the factors which produced them is not simple and obvious on the surface, and we shall have to examine the nature of the connexion.

(b) In the second place, land, labour, and capital differ greatly from ordinary articles of exchange. Labour is unlike other things in the fact that it is bound up in a person and cannot be sold apart from him. This gives it great immobility: it cannot move rapidly where it is wanted. Secondly, it takes fifteen to twenty years to equip a new worker; and hence the supply of labour, either in general or in special occupations, cannot be rapidly increased. On the other hand, it cannot be rapidly decreased, since it is difficult for a man, having learned a trade, to pursue any other occupation. Thirdly, labour is a highly perishable article. To-day's labour unused is never again available. Land again has peculiarities of its own. Unlike most commodities it is strictly limited in quantity. It is a free gift of nature and it has cost nothing to produce. Lastly, capital is peculiar in that it is remunerated, not according to a fixed unit, like an acre of land, or an hour of labour, but according to a variable unit—namely its value. Interest is paid on the £¹⁰⁰ worth of capital.

(c) In the third place, the determination of value differs according as it does or does not take place under conditions of free competition: freedom, or absence of freedom, to buy commodities where one will, affects prices, and this will have to be taken into consideration in the general problem of value. But the question is more urgent and has more serious results in distribution than in exchange. In particular the power in the hands of those who own large quantities of capital has been held to put them in a unique position as compared with those who own only labour, and to have important bearings on the distribution of income.

For these reasons we must attack the problem of the remuneration of the factors of production separately from the problem of the value of commodities. The arrangement of the following chapters will therefore be this:—In the next two chapters we shall deal with the value of commodities. In Chapter IX we shall

consider how value becomes price through the intervention of money. We shall then, in Chapters X, XI, and XII respectively, treat of the rates of remuneration for different units of land, capital, and labour, adding a brief section at the end of Chapter XII on the aggregate shares of the national income going to labour as a whole, capital as a whole, and land as a whole.

CHAPTER VII VALUE

Statement of the Problem

WE deal in this chapter and the next with the factors determining the value of commodities. Note first the elementary conditions of the problem:—

- (a) The economic value of an article is the ratio in which it will exchange for other articles.
- (b) For several reasons, value is not the same thing as price. The prices of commodities can move independently of their value in terms of each other. Nevertheless, since, in ordinary life, value is always measured in terms of price, we shall for convenience use the terms as synonymous. The necessary modifications will appear as we proceed.
- (c) The exchange of commodities can take place under a variety of conditions. Individuals may be free to exchange—to buy and sell—where, when, and how they think fit. Exchange thus takes place under conditions of competition. Or, the individual may be forced to buy from one person or group of persons who completely control the supply of an article. Where such control is complete, we have conditions of monopoly. Or again, a Government may regulate the value of articles. In the last two cases it is usual to speak of monopoly *prices* or regulated *prices*: and to reserve the term value for conditions of free competition. For our purpose, value is that which accrues under the assumption of competition.
- (d) The values of most commodities tend to oscillate

near a point more or less fixed. The value of a four-pound loaf (measured in money) is said to be so many pence. We do not expect to find it so many shillings or so many pounds. There is a normal level about which we tend to find it. On the other hand, the actual number of pence we pay for it may vary: at one time we may pay 6d., at another 8d., at another 10d. The former is called its *normal value*, the latter its *market value*. It is with market values that we are at present concerned.

Our problem then is to account for the *market values of goods, exchanged under conditions of competition*.

The Parties to an Act of Exchange

Every act of exchange implies at least two persons and two things; each person is both buyer and seller; he sells the thing he has and buys the thing the other man has. So also, each thing is both bought and sold. Before the act of exchange takes place both men are actuated by two sets of considerations. A will balance the sacrifice of parting with *x*, which he has, against the satisfaction of gaining *y*, which B has. If the exchange actually takes place, it will be because A and B each thinks that he will gain a balance of satisfaction from the transaction.

As seller, then, each man thinks what his article has cost him, and on that consideration decides on the conditions on which he is willing to part with it. As buyer, each thinks of the satisfaction he will get from the commodity he desires, and so decides how far he is willing to go in order to get it; and value is a result of those two forces of cost and satisfaction. There are therefore three parts in our inquiry:—

- (a) The considerations of cost of production, which affect the seller.
- (b) The considerations of satisfaction, which affect the buyer.

(c) The way in which these interact in the act of exchange.

We begin with an analysis of the factors in the cost of production.

The Seller

1. Let us take first the simple case of one seller thinking of selling one article which he himself has produced. In estimating the conditions on which he will part with it he will take into account the items in its cost of production. He will think of his trouble in planning and organizing, of the effort of fashioning the article and carrying it to the market, of the time it took to make tools necessary for its production; he will think also of the degree to which his tools were worn out, and of the raw materials that were consumed in the making of the article. These are the real costs of production. If we classify them we see that they consist of his own efforts and sacrifices and the waste of material and tools. And it is obvious that he will be unwilling to part with the finished product unless he can get enough for it to recompense him for these costs.

2. We now pass from this imaginary case, to the case of production in the ordinary factory or farm or other business in which large quantities of the same class of commodity are continually in process of production. In this case, while the efforts and sacrifices are not all made by one man, but by different men, yet they are of the same kind. The human efforts consist of thinking and planning, of labouring, or tending machinery; and sacrifice has been undergone by those who have lent their means to supply the necessary buildings and materials for the business. Similarly in production, machines and plant wear out and have to be replaced. Now the organizer of the business gives payment for these costs. He pays wages to his workers for their efforts and interest to those who have lent him capital. He builds up a depreciation fund out of which to repair

or renew his worn-out machines. And he must also credit to himself a payment for his own efforts. Thus the real costs of production, borne by human beings and capital, are changed into *expenses* of production borne by the organizer. And he will require as the price of his products at least sufficient to remunerate him for these payments.

But industries, as we saw in Chapter II, are subject to a law of non-proportional returns. The expenses of producing a unit of produce vary with the amount of produce turned out. Usually, in manufactures, the cost per unit decreases, as production increases, and vice versa in agriculture. In either case the minimum price at which the producer will sell his products, will depend on the quantity he produces in a given unit of time. A manufacturer turning out 10,000 articles a week could sell them at 10s. each; turning out 20,000, he might be able to sell them at 9s. each. This leads to the important principle that *supply and price mean nothing apart*. Supply is always supply at a price.

But this is not all. In large scale industries, cost is not a simple result arrived at by the addition of certain obvious elements. The experience of the Government bodies which during the war undertook the calculation of the costs of producing shells and other things, proves the complicated nature of the task. The difficulty that concerns us here is that which arises from the difference between *Prime Costs* and *Supplementary Costs*. The Prime Costs of any article are the costs immediately and directly involved in its production; and consist of the actual labour spent on it, the actual material used up in it, the actual wear and tear of machinery which its production has involved. These obviously vary directly with the number of articles produced. Supplementary, or General Costs, on the other hand, are the costs which in a large business go on all the time, independently of the actual quantity of production in any day or week. They consist of the salaries of officials

who are not paid directly according to the amount they do; the standing charge on account of permanent plant and machinery; and the rent of buildings. Now, normally the price at which the producer can sell his article must cover not only the prime cost of the article, but also a proportional share of the general costs as well. Circumstances however occasionally arise when the producer is willing to sell his article at a price which barely covers prime costs. But he cannot continue to do so.

Thus, in the second case, the price below which the producer will be unwilling to supply his article (*i.e.* its supply price) is one which must cover its cost of production. It will therefore vary with the quantity produced. Normally it must cover Total Cost; but in exceptional circumstances it may only cover Prime Cost.

3. In ordinary life, instead of only one manufacturer turning out a certain commodity, many rival manufacturers are engaged in the same industry. They differ from each other in efficiency, according to their foresight, judgment, and acuteness in the various activities that make up business. Each producer, so far as he desires success, is continually on the alert to decrease his costs of production while keeping up his output; but some are more successful than others. In each industry the employers stand in different grades of efficiency and at any time there will be one employer who is least efficient on the whole and whose costs of production per unit are therefore the highest. But if his goods are required to satisfy the total demand at the moment, the price of such goods must cover his costs of production; and since the price of the same kind of article is always the same in the same market, all the other producers will be able to ask as high a price as the least efficient producer. If the price were lower than this the least efficient producer would drop out; he could not continue to produce at a price lower

than his cost of production. On the other hand, if it were higher, other producers would be attracted into the industry.

Now under any set of circumstances one firm is the least efficient, or has the highest costs per unit of output. This firm may be called the *marginal firm*, because it is just on the margin of ability to carry on. Hence we can say that the *supply price of a commodity for any given output is the price which will cover the costs of the unit of production of the marginal firm.*

The Buyer

We have dealt with the considerations which affect the seller in arriving at his supply price—or the minimum price at which he will sell his produce. We must now turn to the demand price—or the maximum price which the buyer will be willing to pay for the article. To find out what determines this demand price we shall commence with a simple instance and work up to the more complex conditions of ordinary life.

1. A man desires a commodity because it is the means of satisfying a want. We take first the case of a single person with a single want—say the feeling of thirst—which we will assume can be satisfied only by one thing—water. The power of the water to satisfy his thirst is called its *utility*. Now the feeling of thirst has various degrees of intensity, and therefore equal quantities of water have different degrees of utility under different circumstances. The first cup of water to a thirsty man has a high utility; a second a smaller utility; and as his thirst becomes satisfied there will be a last cup of water which he will hesitate about drinking—its utility may be called the *marginal utility* of the water. Hence, though all the cups of water are of the same size and quality, the utilities of the successive cups are in a descending scale, the utility of each depending on the degree to which it satisfies an existing want. Hence in order to get the first cup of water,

the man will be willing to go to considerable trouble (or to pay a considerable price); he will give less for the second, still less for the third. Now imagine that the utility of the first cup to him can be measured by 4d., of a second by 3d., a third $2\frac{1}{2}$ d., and a fourth 2d. Under these circumstances, if the only water available is selling at 4d. a cup he will only buy one, because the utility yielded by a second is worth less than 4d. to him. But if water is selling at 2d. a cup, he will buy four since he estimates the utility of the fourth at 2d., and of the other three at more than two-pence. In this case he buys four cups of water at 2d. each, and he receives utilities measured by 4d., 3d., $2\frac{1}{2}$ d., and 2d. The utilities are different, but the price he will pay for each is the same; and it is a price measured by the marginal utility. For a smaller quantity of water he would have been willing to pay a higher price per cup, because the marginal utility would then have been higher; for a larger quantity of water he would have given less per cup.

2. But an article may have more than one use. Water may be used for drinking, or cooking, or washing, or for other purposes. Any given individual would consider certain uses the most important and others the least important. Given a supply of so many cups of water, then, an individual would use the first for drinking, the second for cooking, and so on; and if the supply were insufficient for all purposes, he would omit the uses which seemed to him least important. If he had to pay for the water, the maximum price per cup that he would be willing to pay for a certain quantity would be measured by the least important use to which he would put any cupful of it. Thus if he estimated the utility of a first cupful at 4d., of a second at 3d., of a third at $2\frac{1}{2}$ d., and of a fourth at 2d., he would be willing to pay for four cupfuls, $4 \times 2d. = 8d.$; for three cupfuls, $3 \times 2\frac{1}{2}d. = 7\frac{1}{2}d.$; for two cupfuls $2 \times 3d. = 6d.$; and for one cupful $1 \times 4d. = 4d.$ His demand price per cup

depends on the marginal utility, which varies not only with the intensity of his needs, but also with the quantity of water available.

3. In the ordinary market many people want the same things for a variety of purposes. Each individual, therefore, has his own scale of demand prices which he would be willing to pay for different amounts of the commodity. Putting all these together we see that in an ordinary market a certain quantity of an article could be sold at a certain price per unit; a larger quantity could only be sold at a less price per unit; a smaller quantity would fetch a higher price per unit. The reason is obvious. If the quantity is small each unit will be devoted to high uses which are measured at a higher price; if the quantity is large, some units will be devoted to lower uses, whose price equivalent is lower. In every case the actual price at which a quantity will sell is connected with the marginal utility of that quantity.

4. We now take the final step. In ordinary life the wants of men are many and the goods with which these wants are satisfied are many. If man's powers or resources were unlimited, he might satisfy each want to the full. Since they are limited, he must choose which wants he will satisfy and to what degree he will satisfy each. He has to distribute his energies, or "lay out" his resources in the best way. If a man's sole want were a feeling of hunger, he might spend all his efforts procuring food; but since he also feels thirst, he must devote some of his energies to fetching water; and so far as his judgments are correct, he will distribute his energies in these directions so as to get the maximum satisfaction. That maximum satisfaction will not be attained so long as the last few minutes spent in procuring food would have been better spent in fetching water. In the more complex conditions of life, the same truth holds; and a man will have spent his income to the best advantage when the last penny

spent in any one thing brings him as much satisfaction as if it had been spent on any other. For each class of commodities he will pay a price measured by the marginal utility of the commodity to him; and he will try so to distribute his expenditure that the marginal utilities derived from each class of commodity are equal.

Thus we see that *demand price for a certain quantity of a commodity is measured by the marginal utility of that quantity of the commodity*. But this marginal utility is not the last conceivable use to which the commodity could be put; but the least important use to which, in a complete scheme of wants, a man or a community decides to put the commodity.

Demand

This whole conception can be simplified if we introduce the distinction between a demand and a want. A demand is a want accompanied by the willingness and the ability to pay. Men's wants are unlimited, but their economic demands are strictly limited by their resources; and it is demands, and not wants, that count in ordinary economic life. A million children may each want a pair of boots, but it is only the 10,000 whose parents are willing and able to pay the necessary 15s. who have any effect on the boot market. Demand is always demand at a price. A man's demand for any commodity depends on his total resources, and on the amount of his resources that he must spend on other commodities.

As we shall see in a later chapter, the above analysis assumes a perfect freedom of choice and an accuracy of judgment on the part of individuals, which do not exist in actual life. Our present wants are largely habits inherited and developed in the past; and we do not, every time we spend a penny, debate how and where to spend it. But even habitual consumption has been a matter of choice at some time; and questions arise daily as to the advisability of spending a little more

or a little less on some particular object. And in abnormal times our whole system of demands may undergo revolution. During the war, for instance, in spite of the rise in the price of the four-pound loaf, the demand for bread rose, and bread now forms a much larger item in the food of the people than it formerly did. This is because, while the price of bread has risen, it has not risen so much as the price of other things. And every time a man receives an appreciable addition to his income, he has to revise his system of wants, and decide on his scheme of expenditure.

CHAPTER VIII

VALUE (*Continued*)

Market Value

In last chapter we saw that the minimum price at which a producer will sell his commodity (his supply price) is measured by the cost of production of the marginal unit; and that the maximum price which a buyer will give for the commodity (his demand price) measures the marginal utility of the thing to him. And we saw that in the case of both demand and supply, price and quantity are intimately connected.

In the actual market, on the given conditions of a particular day there are so many sellers each with a certain quantity of boots which he will sell at not less than a certain price; and so many buyers willing to pay certain prices for certain quantities of boots. Let us assume that the following table shows the facts of the situation :—

SELLERS.

A	will sell	20	pairs of boots	at	10s. a pair.
B	"	30	"	"	11s. "
C	"	25	"	"	12s. "
D	"	15	"	"	13s. "
E	"	20	"	"	14s. "
F	"	30	"	"	15s. "

BUYERS.

M	will buy	20	pairs of boots	at	10s. a pair.
N	"	15	"	"	11s. "

O will buy 25 pairs of boots at 12s. a pair.

P	"	30	"	"	13s.	"
O	"	30	"	"	14s.	"
R	"	20	"	"	15s.	"

We can write this out in another way:—

At 10s. 20 pairs of boots are offered and 140 wanted.

„ 11s. 50	"	"	120	"
„ 12s. 75	"	"	105	"
„ 13s. 90	"	"	80	"
„ 14s. 110	"	"	50	"
„ 15s. 140	"	"	20	"

At the price of 12s. a pair, or any lower price, the demand is greater than the supply, and the sellers with the higher supply prices will come forward, and the price may rise to 13s. But at 13s. the supply is greater than the demand; therefore the sellers with the lower supply price will offer the boots at less than 13s. in order to sell their goods. There will be a price somewhere between 12s. and 13s. where the supply offered and the number demanded will be equal; at 12s. 8d., for instance, 85 pairs may be offered and 85 bought, and that will fix the *market price* for the day.

In the above example, a certain number of people were suited, but a certain number went unsatisfied. If 85 pairs only were disposed of, 55 pairs remained unsold and unsold. It is unthinkable that this fact would have no effect on future supplies and prices. We must now, therefore, pass from the static conditions of one day's market, in which we took for granted a certain demand and a certain supply; and we must try to find just what determined so many sellers and buyers to come forward. That is, we must see how causes operate under changing conditions. Two points will claim special attention.

(a) We must note the interaction of demand, supply,

and price. We have not till now fixed attention on each separately. In actual life they cannot be separated; nor can it be said that any one of them is the cause of the others.

(b) In the second place we must distinguish between long and short periods. Economic causes seldom get time to work out their full effects. No sooner has a change in demand begun to have its effects on supply than another change begins to act in a different direction. Hence the course of price, or demand, or supply, is as apparently accidental as the course of a leaf floating hither and thither on the surface of a stream. Yet neither is accidental; each is the effect of definite causes: neither the course of the leaf, nor of price, can be other than it is under the given circumstances. But in economics we must sometimes look at the effects in short periods, of causes that are temporary, and sometimes at the effects, in the long run, of causes more or less permanent.

1. The Interrelation of Price, Supply, and Demand

Elasticity of Demand.—We have already seen that there is a relation between the price of a thing and the amount of it that will be supplied or demanded. Demand is always demand at a price: supply is always supply at a price. But the relation is not a mathematical one. To double the price of a thing is not necessarily to reduce the demand for it by a half or a quarter or any other given fraction. The actual effect depends on the nature of the commodity. The demand for some commodities is greatly affected by changes in price, shrinking rapidly as price rises, and stretching as price falls. When the price of bananas is 1s. each, the demand is meagre; when it falls to a penny a piece, they become the food of the poorest. Such a demand, from its characteristics, is called an *elastic demand*. The demand for some other commodities is not similarly affected. Bread, for instance, has generally to be bought

in more or less fixed quantities no matter what its price. The demand for these is therefore said to be *inelastic*. It is not possible to draw up lists of things, the demand for which is elastic and inelastic respectively. Normally, the necessities of life belong to the latter category, and the comforts to the former. But a demand may be elastic in one class of the community and inelastic in another. In the middle classes the demand for motor-cars is greatly affected by their price; but in the case of the very rich who will buy motors at any price, the demand is inelastic.

The Effects of Changing Demand.—This conception of elasticity of demand helps to the understanding of the interaction of supply, demand, and price. Let us try to trace the effects on supply and price, of an increased demand for an article. The first effect will be to stimulate existing producers to meet the increased demand; and new producers may be induced to come in, in the hope of sharing in the rising market. Now we know that an increased supply is in some cases obtainable at a smaller cost per unit, and in other cases only at a higher cost per unit (according as the industry is subject to increasing or diminishing returns). In the latter case, the increasing demand will be checked by a renewed rise in price owing to the greater costs of production. But how far it will be checked, and whether it will settle at a permanently higher level, or revert to the old level again, will depend on the elasticity of the demand for the article in question. Clearly, if the demand is very elastic, the rise in price due to the increased costs of the greater supply, will send demand racing back to its old level. But if the demand is inelastic, it may remain at a permanently higher level in spite of the increased prices.

In the other case, where the increasing supply is obtainable at diminished costs, the manufacturers will turn out increasing quantities of the article until more is being offered than can be sold at the price: price will

therefore drop. How far it will drop and at what level the new demand will settle will in this case also depend on the elasticity of the demand combined with the degree to which supply price varies with output.

Effects of Changing Supply.—The whole course of changes in demand, supply, and price may, however, take its origin on the side of supply. The discovery of a new source of raw material, or of an improved method of manufacture, or a new invention, may enable producers of a commodity to put increasing quantities on the market. This will lead to a lowered price and an increased demand. But where demand and price will settle can be estimated only if we have a knowledge of the nature of the demand and the actual conditions of the supply. In other words, it depends again on the degree to which the demand for the article is elastic and on the effect on supply price of the increasing output.

Effects of Changing Price.—The effect on demand and supply of a changing price follows from what has already been said. But it should be noticed that a change in the price of one commodity may cause a decrease in the demand not of that commodity but of others. It may lead indeed to an all-round modification of one's scheme of demand. A notable instance occurred during the war. The rise in the price of bread had no effect in curtailing its consumption. This was natural, because the demand for bread is inelastic; and since increased prices must lead to a reduction in consumption, the reduction took place in the consumption of other things. But the rise in the price of the loaf was actually accompanied by a great increase in the consumption of bread, owing to the fact that the price of other food-stuffs had at the same time increased in even greater proportion.

2. Long and Short Periods

In each of the above cases, the effects would differ according to whether the changes were merely temporary

or were likely to be permanent or of long duration. We shall examine these differences, so far as they affect the determination of price. We take three cases.

(a) If an increased demand is due only to some passing cause affecting only one day's market (like the effect of a short supply of fish on the demand for meat) the result will only be to raise the market prices for the day : it will have no effect on future supplies and prices. The short period effect, therefore, is a rise in price, caused not by any changes in cost, but entirely by the increased demand for a fixed supply.

(b) If the increased demand, however, promises to last for some weeks or some months the existing producers will attempt to overtake the increased demand by working overtime, running their works at full pressure, and using their existing machinery and labour to the utmost, with the object of increasing output. But such increased output will be possible only at an enhanced cost per unit, since it means paying overtime rates of wages, and working men at hours when they are already fatigued and when output relatively to wages is therefore low. The result will be an increased output, but at a higher price. Thus the effect of an increased demand of a few weeks' duration is to increase prices, owing to the increased supply being procurable only under difficult conditions.

(c) In the case of an increased demand, caused by changed habits, and likely to be permanent, there begins a modification of the whole of the conditions of production of the article in question. Existing firms increase and reorganize their businesses ; new firms start up ; labour and capital begin to flow into the industry ; boys train for the industry rather than for others. The industry will begin to take a more important place. All these things will enable the industry to be conducted more economically, and under such conditions most industries will be able to enjoy increasing returns. Cost of production and price will fall. And though, from time to time there

will be oscillations in market prices due to short period conditions, the general level of price will be lower, owing to the improved conditions of supply. In other words, the *Normal Value* of the article will be established on a permanently lower level.

From the above analysis which aims at explaining only the value of reproducible articles bought and sold under conditions of competition, by individuals alert to get the best advantage from exchange, it is seen that value is a highly complicated phenomenon resulting from conditions of demand and supply which are constantly acting and reacting on each other and sensitive to changes of many kinds. And where articles are not reproducible, or where they are exchanged under conditions of monopoly, some further words of explanation are necessary to an understanding of price.

It should be clear, therefore, that any theory which endeavours to explain all the facts of value by reference either to demand alone or to supply alone, must necessarily be too simple. Such theories nevertheless have had importance in the history of economic thought and must be briefly mentioned.

"The Cost of Production" Theory of Value

Of the Cost of Production theories there are two main types. Both would allow that temporary market values are affected both by demand and supply, but they hold that normal or long period values are determined by conditions of supply alone. The first type—the Labour Theory of Value—narrows the explanation still further and holds that value is determined only by the amount of labour embodied in a commodity. In this form the theory was held by Adam Smith and developed by Karl Marx. In its broader form—as developed by Mill—it allowed for the other elements in the cost of production, including the "profits" of the capitalist. The importance of the theory lay in directing attention to the elements in cost ; but as a complete explanation

of value it is open to many objections. It fails to explain the changes in value of things produced in the past (except by a restatement in which "reproduction" is substituted for "production"); it fails to account for the value of articles of rarity; and it fails to explain why the products of misdirected labour and capital have no value.

The theory arises out of the observation that value tends to equal cost of production. But that is not to say that cost of production determines value. It is almost as true to say that value determines cost of production. Cost of production is as much an effect as a cause.

The "Marginal Utility" Theory of Value

In our analysis of the considerations of the buyer in settling his demand price, we have already brought out the main points in the "Marginal Utility" Theory of Value. The importance of the theory, which was developed in this country by Jevons, following the Austrian economists, was the attention it drew to "increments" of utility as indicators of demand and supply. And it brought into prominence the effect of demand which had formerly been ignored. But the marginal utility theory is as unable to stand on its own feet as the cost of production theory.

Monopoly Prices

We must add a few words in explanation of prices under monopoly. Monopoly conditions are said to be complete or partial when a person or group of persons has complete or partial control of the supply of a commodity. Under such conditions a greater power lies in the hands of the monopolist of deciding prices, than if he were acting in competition with other producers. What the monopolist aims at is the greatest possible difference between his aggregate costs and his aggregate receipts, and that result may best be attained

by charging a moderate price. Suppose, for instance, that the following table (entirely imaginary) states the conditions in the manufacture of cotton thread:—

Output.	Marginal Cost.	Aggregate Costs.	Demand Price.	Aggregate Receipts.	Net Profits.
		Pence.		Pence.	L. S. D.
100,000,000	1d.	100,000,000	1½d.	150,000,000	208,333 6 8
80,000,000	1½d.	120,000,000	2½d.	200,000,000	333,333 6 8
60,000,000	2½d.	150,000,000	3d.	180,000,000	125,000 0 0
40,000,000	4d.	160,000,000	4d.	160,000,000	..

It is obvious that the monopolist, unless he had ulterior reasons, would consult his own interest best by charging 2½d. a reel, because that is the price that yields the greatest net profits. Hence the monopoly price is such that the profit on each article multiplied by the number sold, yields the greatest result. Monopoly prices, then, may be fixed at a considerable distance from cost of production; they approximate to the level yielding the greatest net profits.

A unique phenomenon arising from monopoly conditions is that of *price discriminations*; that is, the selling of the same article at different prices to different persons, or in different localities. Local discrimination is the commonest form. What happens is that in the area over which this monopoly is complete the monopolist sells a part of his total output at a price which covers the prime cost of that part, plus the supplementary costs of the entire output. He can then sell the remainder of his output in another area where he has not a monopoly at a price which just covers prime costs, thereby being able to compete on advantageous terms with producers of the same article in that other area.

A common type of such discrimination in prices is known as "dumping." This is the case where the monopolist sells goods abroad at a price below their

cost of production, recouping himself by charging a higher price for those he sells at home. It is most easily carried on where the monopolist's industry is protected in his own country by tariffs, and where he has also access for further sales to a free trade country.

CHAPTER IX

THE LEVEL OF PRICES AND FOREIGN EXCHANGE

Values and Prices

WE have so far dealt with the relative values of things, and we have spoken as if price and value were the same phenomenon. But it must now be pointed out that price is value measured in terms of money; and that prices may alter while the value of things in terms of one another remains constant. At the present time this requires little demonstration. Meat and sugar may have the same relative value now as they had in 1914, but the price of both has risen. Thus a change in the general level of prices may coexist with absence of change in relative values. Or again, it may accompany changes in relative values.

In either case we have a phenomenon which may not be entirely attributable to change in the value of commodities; but may be attributable to a change in the value of money, in which prices are measured. If the weights of twenty different articles appear to-day to be 50 per cent. greater than they were yesterday, the presumption would be, not that all the twenty articles had increased in weight, but that the weights we used were at fault. That contingency would be unlikely, but it is quite possible in the case of prices, the standard of which, namely money, is by no means invariable.

The difficulty of ascertaining exactly what has happened when a great change in prices has taken place is due to the fact that we have no absolutely stable measure of value against which to test, on the

one hand, commodities and, on the other hand, money. If we doubt our weights we can test them against the standard weights of the local authorities ; but we have no fixed standard of value. We can, by a device known as Index Numbers, find out what change has taken place in the purchasing power of money, and this is of great use for practical purposes. But it still leaves undetermined the question to what the change is due—whether to some change in the conditions of the demand and supply of goods, or in the conditions of demand and supply of money.

The Value of Gold

In the last chapter we dealt with the problem of the value of commodities. Here we shall confine ourselves to the value of money.

To begin with we shall assume that the only money in use is gold, and that all the gold is in actual use as currency. Now, gold being a commodity, its value is subject to the influences of demand and supply. Hence, if the quantity of ordinary commodities remains constant, an increase in the supply of gold will lower its value as measured in commodities. In other words, the price of commodities will rise ; and similarly a decrease in the supply of gold will lead to a fall in prices. Thus, if there are 100 articles and 100 sovereigns in circulation, the average price of an article will be one sovereign ; if the sovereigns are increased to 200, the average price of the commodity will be two sovereigns. But obviously, if at the same time the quantity of commodities had increased in the same proportion as the gold, no change would have taken place in prices ; and if commodities had increased in a greater proportion than gold, prices would have fallen. To account for a change in general prices then, we must take into account not only the gold in existence but the volume of the trade and industry in which it is used.

There is still a third factor to be taken into account.

The demand for gold depends not only on the number of commodities, but on the frequency with which these commodities are exchanged. If A has a house and lives in it permanently, its existence does not make a demand on gold ; but if he sells it to B this week, and B sells it to C the next, and so on, gold will be required for these transactions ; and the increased demand for gold will raise its value and therefore lower prices.

Thus the general level of prices depends on three factors : (a) the supply of gold, (b) the amount of other wealth, (c) the amount of work the gold has to do.

The Value of Money

But gold is not the only thing that is used as money. Exchanges can be brought about through the medium of bank-notes and credit instruments. As far as such things exist, they have the same effect on prices as their equivalent in gold. But the number of such instruments in any country is roughly limited by the amount of gold. Credit, as we have seen, has a gold basis.

Therefore, while non-metal instruments are a very important part of currency, they are not, in normal times, an element which can expand indefinitely independently of gold. The amount of gold therefore is directly or indirectly the important factor in determining the value of money.

(It should be noted that during the war period the restrictive influence of the gold reserves on the expansion of credit was considerably lessened by the issue by Government of an emergency legal tender currency in the shape of Treasury notes, the quantity of which was not limited by law. This made the loans of banks independent of their cash reserves, and therefore led to a great absolute expansion in the non-metal currency.)

International Values

Each area which has its own currency and banking system has its general level of prices determined by the

factors we have considered. But is there any connexion between the general level of prices in different countries? There is such a connexion, and it is effected by means of that credit instrument which does not stop short at political boundaries but is used for international trade—namely, the Bill of Exchange. We have already described the technical side of bills of exchange; let us now look at their influence on international prices.

We have already seen that bills of exchange are bought and sold by merchants. But the price at which they exchange depends on the state of trade between different countries. We imagined in the example that there was equal indebtedness as between two countries. In actual life this seldom is the case. Trade takes place, for example, not only between England and Australia, but between Australia and America and between America and England. Now since gold seldom passes, the total exports of England must be roughly equal to her total imports. But that does not mean that her exports to any one country—say Australia—will be equal to her imports from that country. At any time England may be importing far more goods from Australia than Australia from England. In that case merchants in England will be eager to buy bills on Australian merchants, and there will be few of such bills to satisfy the demand. Those who hold the bills, therefore, will be able to get a higher price for them than their face value.

But there is a limit of price beyond which buyers of bills will be unwilling to go. This is fixed by the alternative ways that lie before the English merchants of paying their debts. It is always open to them, in ordinary times, to send the actual cash to Australia. It is not normally done, because transport is high, and there is a risk of shipwreck and loss. The cost, let us say, of sending £1 to Australia (including insurance) is 8d. Obviously, therefore, merchants will not offer more than £1, os. 8d. for a £1 bill. This is the maximum limit. On the contrary, if the balance of indebtedness were the

other way round, the holders of bills would have to accept less for them than their face value, but they would not accept less than 19s. 4d. These two limits, 8d. above and 8d. below, are called the "gold points"; they are the points at which it would pay as well to transport cash, or gold, as to buy or sell bills. Hence the value in England of a sovereign in Australia varies from 20s. 8d. to 19s. 4d.; and its actual value at any time depends on the state of trade between the two countries.

Where the countries in question have different currency systems, the principle is the same, although the question is complicated. Here we can only indicate the general principles of "foreign exchanges."

Suppose the trade we are considering is between France and England. Now the value of the gold in an English sovereign is equal to 25.225 francs; and this equivalence is called the "mint par." Further, to send a sovereign from London to Paris costs, let us say, .08 francs. It follows that the "gold points" for the purchase and sale of London bills on Paris or Paris bills on London are 25.145 francs and 25.305 francs. Now when England has been buying from France more than France from England, the value of the English sovereign will fall below mint par, or in other words, the exchange will be "against us." If it turns so much against us that merchants would rather ship gold than send bills to Paris, then this transmission of gold begins to take place. It is here that prices begin to influence each other internationally. V

Note what happens. We have imagined that France had exported far more goods to England than England to France, and that in consequence gold began to flow from England to France. The consequence is that the supply of gold in England is reduced and the supply of gold in France is increased. But we have already seen that a reduction in gold means a rise in the value of money, or a fall in prices; and an increase in gold a rise

in prices ; so that the result of the transfer will be a fall in prices in England and a rise in prices in France. This will have the effect of inducing the French to purchase more goods from England and the English to purchase less from France. The exchanges will therefore begin to move ; and the value of the sovereign will approach its mint equivalence in francs.

Now the lack of equivalence of exports and imports may exist, not only between England and France, but for a limited period between England and the rest of the world. If we look at a long enough period, exports must balance imports : but for months England's total imports may exceed her total exports (visible and "invisible"). In normal times, however, this state of things cannot last indefinitely. Sooner or later the result will be the export of gold from England to foreign countries, a fall in prices in England, and a rise in prices elsewhere ; a consequent gradual reversal of the situation, and the growth of purchases from England and the decrease of purchases by England. Thus bills will become more plentiful in England and less plentiful abroad ; and the foreign exchanges which were against us will turn in our favour. The exchanges, therefore, tend to oscillate about par.

We therefore reach the conclusion that, in the long period, the general level of prices is influenced by the increased supply of gold ; because in the long period gold does pass from country to country, flowing to countries where prices are low, and from countries where prices are high. But in the short period the important factor in determining the general level of prices within a single country is the supply of gold in that country ; for gold does not move easily. There are other ways of effecting payments than by shipping gold, and it is only transmitted when conditions make the alternative ways less advantageous than the transmission of gold. Hence in the short period we must look on the gold in a country as immobile, and the influence of foreign gold inactive.

(The state of the foreign exchanges during the war and subsequent months is too complicated a subject for treatment here. The vital points to note are : First, the virtual prohibition by Government of gold exports during the war (given legal sanction in 1919), which removed the natural limits of the movement of foreign exchanges. "Gold points" were practically non-existent, and rates were therefore free to move up and down indefinitely. The result was wide fluctuations in rates of exchange. Secondly, the decrease in the volume of ordinary bills (by as much as three-fourths between July 1914 and July 1919), and their substitution by Treasury Bills. Third, the reduction in our exports due during the war to concentration of effort on war work, and subsequently to our failure to settle down to production. The result of five years of war conditions was by August 1919 an increase in purchasing power of the English pound of 1s. 9d. as compared with the average purchasing power of sixteen foreign currencies (omitting the German and French currencies, in which the value of the pound sterling was much higher). During the same time, however, the value of the English pound in American dollars had fallen by 15 per cent.)

CHAPTER X

THE PAYMENT FOR THE USE OF LAND

BEARING in mind that the economic problem of distribution is one of explaining the share in the national income which goes to different factors of production, let us begin with the problem of the share that goes to land, or natural resources.

Unique Characteristics of Land

Land, considered as superficial area, differs from every other factor of production in being *definitely limited in quantity* and incapable of increase. In technical terms, it has no supply price : no price offered is sufficient to call into being another acre of it. The land that exists has been put there by nature and has cost nothing to produce. On the other hand, it is *permanent* ; whether used or allowed to lie idle, it will not decrease in amount.

But from the point of view of economics it is not the superficial area of land, but its qualities as a factor of production that are important : and as such it is neither absolutely limited nor absolutely permanent. It can be modified, and that in two ways. By the economic action of individuals its fertility can be altered, and through the social action of the community, its availability for productive purposes can be improved. Land once inaccessible can, through the movements of the population, the building of roads and so on, be brought into production. Hence the economic qualities of land in an old country are of three kinds :

(a) Its *natural* qualities, which are original and un-

alterable. Such are, the lie of the land and its climatic conditions.

(b) The qualities it has acquired through *economic* action—for instance, improvements in fertility.

(c) The qualities due to the *social* action of the community. These are chiefly questions of situation.

Meaning of Rent

Every piece of land differs from every other in one or more of these qualities, and is therefore of greater or less use in production. And while it is impossible to separate its natural qualities from those which are acquired, yet its importance in production is the result of the combination of both sets of qualities. Hence, the share of the national income which goes to land (or rather to its owner) being a measure of its economic service, is due to qualities some of which are natural, some due to social action, and some to economic action. The income of the landlord, therefore, is a composite income. Part of it is a return for improvements made in the land by him or his predecessors : this is properly interest on capital expended, and as such will be considered in the next chapter. The other part is a payment for qualities for which he is not responsible, being partly original qualities and partly advantages due to the action of the community. This part of his income is economic rent. In actual life it is impossible to separate these elements ; but to understand the nature of the different kinds of income, we must hold at first to this distinction.

Ricardo's Theory of Rent

In considering the nature of rent, we shall first follow the general argument of Ricardo, who built up the theory of rent which in its broad outlines has been generally accepted by English economists. But Ricardo, defining rent as "the payment made to the landlord for the original and indestructible powers of the soil," emphasized the element of "fertility" at the expense of

"situation." To include both of these factors in the usefulness of land, we shall speak of the "advantages" of one piece of land as compared with another. We shall then note several questions raised by Ricardo's statement, and bring the theory into line with later developments.

Extensive Cultivation.—Land has many uses; but its most important use is in agriculture, and we shall confine our attention first to its employment in one branch of agriculture—wheat-growing. In a new country with a sparse population, the land will at first be cultivated extensively, and those pieces of land with the greatest net advantages—of fertility combined with accessibility—will be the first to be cultivated. But as the population increases and the food supply raised on these first pieces of land becomes inadequate, less advantageous soils will have to be taken into cultivation. Now, with the same expenditure of labour and capital, the produce per acre raised on the "best" land will be greater than the produce per acre from any other piece of land. In other words, the cost per bushel of wheat raised on the best field will be less than the cost per bushel on any other field.

Next, there will at any time be under cultivation one piece of land which is less productive than any of the others then in use; and on which therefore the cost of raising each bushel will be highest. Such a piece of land will be cultivated at all only because without it the food supply would be insufficient. It may therefore be said to be on the *margin of cultivation*: a slight decrease in the population will put it out of use. On the other hand, an increase in the population will bring into use another field with still greater disadvantages; and this latest field will now be the one on the margin of cultivation, and the cost per bushel of wheat raised on it will be the highest of all.

Now in order to induce some one to continue cultivating this marginal land, the population will have to

pay for his wheat a price sufficient to cover his costs of production, plus a normal profit for himself. But since the wheat from all the other pieces of land goes to the same market, it will all sell at the same price as the wheat from the marginal land (assuming that it is of the same quality). This price, however, will be more than sufficient to pay the costs of production (plus normal profits) on those superior soils; and therefore in each of them the price of the products sold will yield a surplus over costs of production. This surplus is what is known as economic rent, and it is clear that the rent of any piece of land is measured by the difference between the cost of raising the wheat on that piece of land and the cost of raising it on the marginal land.

Hence it follows, first, that marginal land yields no rent; second, that every piece of land above the margin yields a rent whose amount depends on its superiority over the marginal land; and third, that this rent emerges independently of any particular form of ownership or tenancy. To elaborate this third point: if each piece of land is actually owned by its occupier, each of these, except the marginal one, receives rent and pockets it. If on the other hand, one man owns all the different lands and lets them to different tenants, the possible tenants will compete against each other for the best soils and will be willing, if necessary, to pay for the use of any piece of land a sum equal to its rent. The rents in this case will therefore go into the pocket of the landlord. Hence, under any system of tenancy, where land is cultivated extensively rent emerges.

Intensive Cultivation.—But land can be cultivated intensively as well as extensively. The needs of a growing population may be met, not by opening up new tracts of country, but by applying more capital and labour to fields already under cultivation. For extra expenditure will lead to increased production. But since land, as we have already seen in Chapter I, is, apart from improvements in conditions, subject to a

law of diminishing returns, extra expenditure on the same soil will meet with less than proportional returns. In other words, extra wheat can be raised from a single piece of land only at increased cost, and consequently, under any given set of circumstances, there will be a point beyond which it will not be worth while applying any more capital and labour with the object of raising an increased crop from the same field. In other words, just as there was a marginal piece of land in extensive cultivation, so there is a marginal "dose" of labour and capital in intensive, and the extra produce due to this marginal "dose" will only just pay for its cost of production. It follows that the produce raised by all the previous "doses" (which were more productive) will yield a surplus over their costs; and this surplus is the same phenomenon as that which appeared in the case of extensive cultivation. In the former case it was due to the superior productiveness of one piece of land over another: in this case it is due to the superior productiveness of one degree of cultivation over another. In both cases it is the same thing, namely, rent. And here also it emerges independently of any particular system of tenancy. An owner-occupier will himself retain the rent: an owner, as independent from a user, will be able to divert it to his own pocket, since the tenant, anxious for as large profits as possible, will cultivate as intensively as circumstances permit.

Thus rent is a differential result. It is due to the differential advantages of one piece of soil over the marginal land in extensive cultivation and to the differential advantages of different doses of labour and capital applied to the same land intensively cultivated.

The Relation of Rent and Price

If the analysis above is correct, rent would not emerge at all but for the fact that land is a free gift of nature limited in its best qualities. Hence rent differs from the payment for the other factors of production, which are

not free gifts, and not limited. Capital and labour can be increased as productive factors, but only at a cost; and their payments (interest and wages) must be made to them if they are to take part in production. Hence interest and wages must be covered by the price of the commodities which labour and capital unite to produce. They help to determine prices. But not so with rent. The productivity of the land is not affected by the payment of rent, and therefore rent does not enter into prices. This strange conclusion is supported by the Ricardian theory of rent, which shows that the price of wheat is determined by the costs of production on the marginal land, which pays no rent.

The conclusion is strange, because we usually think in such questions from the point of view of the individual. The individual farmer must certainly get for his produce a price which will cover rent, in addition to his other costs. But even if he sat "rent free" he would still get the same price for his produce, for it is measured as we saw by marginal costs. So long as we have private property in land, even if every landlord refused to accept rent from his tenant, the price of goods would not be lowered. If, on the contrary, land were State-owned, it might be possible for the State to sell produce at a price lower than that which would cover marginal costs, and to compensate itself for the loss incurred on the poor lands, by the surplus yielded by the best lands.

Other Explanations of Rent

Ricardo's theory explains rent entirely on the basis of the differential advantages of different soils. Recent contributions suggest other reasons for the existence of rent. In particular, there are two other explanations which we may briefly allude to. The first begins with the fact that in old countries land is scarce. If land were only used for growing crops, this would not matter so long as land was plentiful elsewhere. But land has other

uses : it is used for sport, for pride of possession ; and for these purposes, land in other countries does not count. The scarcity of land then enables the owner, even of marginal land, to get for it a payment which more than covers the costs of its upkeep. The excess on the other hand is not a differential rent. It may be called a *scarcity rent*. Further, the poorest land under wheat at any moment might be relatively good pasture land. But it is used for wheat because it thus yields a better return to labour and capital than if it were put under pasture. That is, the marginal wheat land yields a rent which is due to the *alternative uses* of land.

If the reader has grasped the essentials of rent he will be able to apply the conception to land used for building and to mines. He will also be able to work out for himself the effects on rent of changing conditions. The differential advantages of land are not permanent. Improvements in transport, the growth of cities, the building of tramways, affect the situation values of different lands : the opening up of new countries gives access to new supplies of food and changes the habits of the people ; and all those things affect rents.

The importance of the Ricardian theory of rent is that it seemed to put land into a unique category and explained rent as a unique kind of income. We shall see in later chapters that the differences between land and other forms of capital are not so great as Ricardo imagined, and the development of economic thought has suggested a close relation between rent and the payment for other factors of production.

Everyday Rent

It was pointed out earlier in this chapter that in all so-called "rents" there is an element of interest, due to capital embodied in the land : and to be distinguished from rent which is payment for natural qualities. But in fact this distinction gets blurred. Capital improvements in land tend to become assimilated with the land

itself, and their payment comes to partake closely of the nature of rent. Common language is not far wrong when it insists on giving the same name to the payment for the use of all kinds of immoveable property.

Under conditions of competition the ordinary rents paid in everyday life are explained by the economic considerations brought forward in this chapter : but in thickly populated centres emphasis is shifted from the differential income due to advantages in fertility to the "unearned increment" arising from differences in advantages of situation.

Conditions of pure competition, however, seldom hold, and it is largely on this account that ordinary rents seem to defy explanation on the Ricardian theory. Note briefly several exceptions :

(a) Many rents are customary rents. Where there is a personal tie between landlord and tenant, farms are often let below the rent they would fetch in the open market.

(b) On the other hand, where districts are congested, and the people, as in the Highlands of Scotland in past times, refuse, through sentiment or for other reasons, to leave their native land, owners may be able to extract rents which are unduly high and leave only a bare living for the tenant.

(c) In such cases Government intervention sometimes supervenes and rents are fixed by law. The legal fixing of rents (in the case of houses) occurred during the war.

(d) Under leasehold systems rents may be fixed for a long term of years and remain unchanged through changing economic conditions.

CHAPTER XI

THE PAYMENT FOR THE USE OF CAPITAL

OUR subject in this chapter is the payment made for the use of capital in its various forms. The peculiarity of the problem, distinguishing it from the problem of rent and of wages, lies in the nature of the unit of capital that is paid for. Rent is paid for the acre of land and varies with the value of that acre in production; therefore rents per acre are different. Wages are paid for the hour or the product of labour, and vary with the value of that product: therefore there are different rates of wages. But the payment for capital is made for the *value* of the capital: we borrow £100, or £5, or £1, and pay so much for this value. We would expect therefore that the remuneration of capital would be uniform: £100 is always equal to £100. We may, indeed, borrow concrete capital and pay varying amounts for the use of it for a certain time: we can hire a bicycle at so much an hour, or a motor-car at so much a year. But in ordinary industry the borrower borrows fluid capital (so many pounds), and with it buys the concrete goods he needs.

Fluid and Sunk Capital.—Capital, we have seen, is saved wealth. The savings are in the first instance in fluid form: they are not concrete things. The baker who saves £50 does not save some of the loaves he has produced. What he saves is part of his income—a general claim to goods to the value of £50: and in saving it he refrains from making immediate use of this claim.

But this fluid capital can take definite shape. Some one borrows this £50 from the baker and with it buys a

machine. From that time forth that particular £50 is fixed in shape. It can never be anything else than this machine until it is scrapped. And in such form it is definitely ear-marked to perform a certain function.

The Price of Fluid Capital.—Capital in the fluid state yields no income to its owner until it is lent to some one. When it is lent we would expect that every £100 of capital would be paid at the same rate as every other £100; and in fact we hear of a "general rate of interest." But the lender of the capital, in deciding how much he will ask for his capital, bears in mind two things. First, that he loses the possible use of it so long as it is lent (and that applies equally to all fluid capital); and second, that he risks the failure of the borrower to pay it back in the future. It is this second fact that has most importance in bringing about the payment of different rates for the use of the same amount of fluid capital. The owner of the capital will ask for his loan a sum made up of two elements: (a) payment for the use of his capital—namely, interest; and (b) compensation for the risk of losing his capital altogether—which is more properly called profits.

The Return to Sunk Capital

We now assume that fluid capital has been borrowed (at a price) and that the borrower has bought with it certain machinery and plant for carrying on a business. Out of the value of the produce of his business he must pay all the wages and salaries of his employees, the rent of his land and buildings and depreciation for wear and tear, and allocate a normal payment to himself for his own work; and there must still be enough left to enable him to pay the agreed sum for the fluid capital which he borrowed. If the surplus is consistently less than this, he will ultimately have to go out of business: if it is more, he will have a balance which may be disposed of in various ways. In any case, if the business is to live, the capital in the shape of machinery must be able to

"make" (in co-operation with labour) enough to pay the price of the fluid capital which was originally borrowed. In actual fact, it will in some cases make more than this (if the business is successful), and in other cases less (if the business is a failure). But there must be some connexion between the price normally paid for borrowed capital and the yield of that capital when it is embodied in machinery used for production. We shall have to trace this connexion.

The arrangement made between the owners of fluid capital and its borrowers as to the disposal of any surplus yield from the capital in production varies. In the private firm, the fluid capital is borrowed at a fixed rate which the lender receives independently of the success or failure of the business; and any surplus due to the success of the business is retained by the employer as profits, and any loss is borne by him. In the Joint Stock Company, different methods are used, as already explained. Debenture shareholders are paid a fixed rate guaranteed them on the security of the business: they therefore risk nothing, and their payment is entirely interest for the use of their capital. Ordinary shareholders receive a dividend which varies with the fortunes of the business, and is therefore partly interest for use of capital, and partly payment for risk—or profits.

Why is Interest Paid?

Much has been made of the question why interest should be paid at all. There is nothing occult in it. It follows immediately from the fact of private property. Given that institution there is no more reason against having to pay for capital than against paying for a pair of shoes.

But the question may be pressed why payment should be continuous. When one buys a pair of shoes one pays 30s. over the counter and the transaction is complete. But when one borrows £100 one agrees to pay, say, £5 every year for as long as the £100 is retained, and at the

end of the period to repay the complete sum originally borrowed. To explain this peculiarity involves some reference to what occurs when capital is borrowed and lent. We will consider first the side of the borrower.

The Borrower.—The borrower of capital, whether he wants it to pay off monetary obligations (as a State organizes a Victory Loan to consolidate its miscellaneous borrowings), or to buy consumable goods, like a house or a motor-car, or to buy productive goods like machinery; or whether he actually borrows or hires a concrete piece of capital, borrows a power which may last in perpetuity. This can best be made clear by an example. I hire a motor-car and agree to pay £60 a year for it, so long as I have it, and to keep it in repair, which costs me, say, £40 a year. It would be all the same if I agreed to pay £100 a year for the use of it and left the owner to do the repairs. In either case I value the use of the car at £100 and the owner is willing to lend it for a net £60. Here it is obvious that I have continuous use of the car, and the car continues to exist as a piece of useful property. Now if I had borrowed in order to buy a machine for use in industry, the circumstances would have been similar, with the possible difference that instead of keeping the machine in repair all the time I should have built up a depreciation fund with which to replace the worn-out machine by a new one. In both instances the borrower has the continuous use of a power which exists in perpetuity.

Of course all capital does not consist of durable things like buildings and machinery. "Circulating" capital, like coal burned in the furnace of a factory, disappears in one use. Nevertheless the difference between "fixed" and "circulating" capital is only one of degree. From the given product of a business the worn-out capital, fixed or circulating, is replaced, and the lender of the original piece of capital receives as interest less than he would have done if this replacement had not to be made.

In fact there is no essential difference between the return which industry has to make to the capital employed in it, and the return it must make to the labour employed in it. In both cases the return consists of two parts: (a) a replacement fund, sufficient to replace worn-out capital, or to preserve the efficiency of labour, and (b) a payment over and above this wear and tear fund, in payment for the use of the factor. There is a difference in the way the payment is made. In the case of capital the two payments—depreciation and interest—are quite distinct; in the case of labour they are combined in one payment—wages. Unfortunately, there have been times when labour has received as payment less even than enough to preserve efficiency—where industry, in other words, was not keeping its working agents in good repair.

The Lender.—The lender of capital gives over the use of a thing which has cost something. What is the cost? (a) We exclude the fact that it has cost labour. For one thing it may have cost its owner nothing, having come to him by inheritance. In any case, if it cost labour, that labour was paid for and the transaction is completed. (b) But labour is not the only form of human effort or cost. Just as real is the effort of will involved in refraining from the immediate use of a possession and parting with the possibility of using it for a longer or shorter period. This is what is involved in the lendings of capital.

We must, however, guard against giving this effort a moral colour. Much has been said of interest being a "reward" for "abstinence," while a wage is spoken of only as "payment" for work. There is no justification for seeming to set the effort of saving in a higher moral category than the effort of brain and muscle involved in working. On the other hand it is no valid answer to the contention that interest is a payment for the effort of saving, to point out that much saving involves no effort at all. It is true that the savings of a Carnegie require

no effort; despite Mr Carnegie's life-long endeavours he was unable to spend his wealth; and to-day there are many Carnegies whose fortunes accumulate automatically. Now if the capital of the Carnegies were sufficient for the needs of the world, none of it would cost effort, and no interest would have to be paid. But these savings are not sufficient, they have to be supplemented by the earnings of small men to whom saving does imply sacrifice of immediate enjoyments, and therefore they have a cost of production. Such savings therefore have to be paid for in order that they may be forthcoming, and since the market for capital is competitive, the Carnegies can get a similar payment for theirs.

The cost of capital has two aspects. There was the original effort of saving; and there is the continuous effort of "doing without" all the time that the capital is lent. Again, it is objected that the original effort of saving may not have been performed by the person who now draws interest; but we are not concerned with the personality of the individual to whom the interest goes, but with the fact that interest has to be paid. The question of individual as against collective property in capital affects the problem of the recipient of interest. But it does not touch the fact that capital is useful in industry, that it has cost effort, and that consequently it must be paid for.

Unequal Rates of Payment for Capital

It has already been suggested that we might expect the payment for the use of capital to be uniform within the same market at the same time. But in fact different rates are paid. Government War Loan Stock yields 4½ per cent.: money-lenders charge up to 40 or 50 per cent.; banks give a low rate of interest—round about 3 per cent. on deposits, and lend to stockbrokers at even a lower rate; ordinary companies pay dividends varying from zero to 30 or 40 per cent., and a company

even pays different rates to different kinds of shareholders.

Now the explanation of these variations is that the payment to the lenders of capital contains three elements: (a) pure interest for the use of capital; (b) a payment for risk; and (c) a payment for trouble or work or inconvenience. Thus the total income of a private employer, using his own capital in business, consists partly of interest on capital and partly of payment for his own work of organizing. The money-lender accommodating a bankrupt client, has to take the risk that his loan may never be repaid. The rates of payment for investments abroad are higher than for investments at home, because the investor knows less of the conditions of the industry and therefore risks more. The stockbroker gets cheap money from the banks because he accepts it on the inconvenient terms of a "short loan." The apparent variations in the rate of interest then are due to the fact that it covers elements other than real interest, namely profits and insurance against risk.

The Rate of Interest on Fluid Capital

At any time, there is so much capital already sunk in industries of different kinds. At the same time there is so much fluid capital which has not yet taken definite shape, is not engaged in industry, but will go where the greatest advantage offers. The problem of the rate of interest on this capital is simply a case of the problem of value, and we have two main forces to consider; the supply of capital, or the considerations affecting the lenders; and the demand for capital, or the considerations affecting the borrowers.

The Supply of Capital.—The forces that have led to the accumulation of just so much capital lie in the past. People have been induced to save, or not to save, by the anticipation of a certain rate of interest, and we have already considered, in another chapter, the relative effects on saving of a high and a low rate of interest.

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Given this amount of accumulation, its owners are willing to lend it to certain industries, or to withhold it, according to the relative advantages. The owner might use it for immediate gratifications, or might himself apply it to industry. He will balance against these possible uses of his capital, the advantages of lending it, and he will take into account not only the actual rate of interest offered, but the risk of the undertaking in which it is to be employed and the terms of the loan. The issue may be in the form of ordinary shares in a company, and the owner of the capital will inquire into the conditions of the company, its prospects of success or failure, and the prospects of securing a large or a small return for his money. In all the circumstances, so much capital will be forthcoming at a certain offered or anticipated rate of interest; and at a lower rate so much. There will be a supply schedule for capital.

The Demand for Capital.—In spite of recent war borrowings, the industrial use of capital is still its most important use, and its productivity in industry is the governing factor in determining interest. In particular industries employers are led to borrow or not to borrow additional amounts of capital according to their estimates of the yield of that capital applied in their business as compared with the current rate of interest. Prospects of a higher yield through the application of more capital will lead certain employers to demand more; and this will affect the rate of interest. Altogether, for any particular industry one could draw up a scale of demands for different amounts of capital at different rates of interest.

As in the case of an ordinary commodity, then, the value of new capital is determined by the interaction of demand and supply; it is a case of the general theory of value; and the reader should try to introduce the conception of the "margin" as was done in dealing with the value of commodities.

We have so far spoken as if the problem of new capital

were distinct from capital already sunk in industry ; and have assumed that the latter capital does not form part of a possible supply that might be tempted to come forward by a certain rate of interest. This assumption is not entirely justified. Capital already sunk in one industry can be and is transferred to others. A man can sell his shares in one business and buy shares in another. We have left this explanation till now, in order to bring out the connexion between the rates of interest earned by new capital and the yield of capital already sunk in business.

New capital is but the fringe on the fabric of capital which has already been woven and has taken a definite shape. It has in the past been embodied in certain industries, some of which have been successful and yield a large return to capital ; some unsuccessful and yielding little. Now if all capital were mobile it would move into those which offered the higher remuneration and out of the others, and the rate of interest on all capital would be uniform. But capital is not mobile, and cannot move rapidly out of decaying industries into flourishing ones. The actual machines cannot be transferred. They are ear-marked for definite processes. Nor can the shares in a decaying business be easily sold, for where they are yielding a low rate of interest, they will fetch only a small percentage of their original value. What happens, therefore, is that as the capital in such a business decays, it is not replaced ; and no new capital is taken into the business. But this may be a slow process, and in the meantime the capital actually sunk in the industry is earning a low rate of interest. In the contrary case of a prosperous business, a high rate of interest may be earned for a time. In both cases, in the long run, the amount of capital in the business will adjust itself to the changing conditions of demand, and the rate of interest will tend to come to the general level. But in both cases there are short periods, during which the actual capital in the industry earns an exceptionally large or an ex-

ceptionally small rate. During these short periods the higher or lower rate earned is a result of the special demand on the fixed supply of capital. For this reason interest on capital during a relatively short period has been likened to the rent of land, and has got the name of *quasi-rent*. As we have seen, the peculiar nature of rent is due to the fact that land of various qualities is limited in amount ; and that its productivity is not affected by the payment that it receives in the form of rent. If we consider the short period only, capital has the same qualities.

It is not necessarily the case that the actual shareholders in a company which is paying high rates of interest (which are of the nature of rent) is the person who actually benefits by this high rate. Capital in a highly successful business rises in value ; and for a £100 share yielding 10 per cent., one may receive as much as £200. If then a person has paid £200 for a £100 share and receives the nominal interest of 10 per cent., he is actually receiving only £5 on each £100 he has paid. It is the owner of the original share who benefits in this case.

To sum up : (a) If we consider a long enough period, we find that the rate of interest as such tends to be uniform, and to be determined by the total supply of capital in existence and the total demand for capital. Where the supply of capital is great relatively to the demand for it, it will already have been applied to all its most important uses and there will be enough left to be used for the least productive purposes ; and since any £100 is as good as any other, the rate of interest will be low, being measured by the uses to which the "marginal" units of capital are put. In the contrary case, where demand for capital is high relatively to the supply of it, the rate of interest will be high. (b) But in short periods, in which there is not time for capital to move out of or into particular uses, some sunk capital will be in a privileged position and earn rates higher than the normal.

Such rates are of the nature of rents, and are a result and not a cause of prices.

Profits

Adam Smith, in dealing with different kinds of incomes, divided them into three: the wages of labour, the rent of land, and the profits of stock. He made no distinction between profits and interest; and that was natural, since, in his day, interest and profits came to the individual as one undifferentiated sum. The employer, who received profits, was usually his own capitalist. But with the growth of new forms of business in which the owner of capital has gradually separated from the owner of the business, a distinction has been made, and the capitalist has received the interest and the owner of the business the profits. Even to-day, however, this distinction is not universal. Where the capitalist-employer still exists, he is still the recipient of a compound income; and the ordinary shareholder in a company gets in his "dividend" an element both of interest and of profits. But the distinction is real enough as a fact of economic life, to have led to a distinctive treatment of the two things. Hence we have spoken above of interest as the mere payment for the use of capital, and of profits as a payment for risk.

The risks which are undergone by the owner of a business are always risks of financial loss. But they are due to two main causes. The first is that modern production is always production for a future demand. Employers must anticipate. They expect that for their particular commodity there will be a certain demand, and they work accordingly. But all such anticipations, even in the most stable conditions, are liable to be falsified by events. The demand may be smaller than they anticipated, and they will be left with stock on their hands which they may be forced to sell at a loss. And events are often far from stable. A change in fashion, a change in weather, a sudden decrease of

population, will affect future demand; and the owner of a business must take such risks.

In the second place, risk arises as a natural result of the system of competition. Where firms in the same business are rivals they conceal their methods and their aims from each other. The endeavour of each is to capture as large a proportion of the market for a certain commodity as possible. And so far as a firm is efficient, it will anticipate, with considerable accuracy, just what proportion of the total demand for the commodity it will be called upon to supply. But since there is no centralized knowledge under competition, mistakes are liable to be made. And this again, so long as competition rules, is a risk that must be run.

Some of the restrictions on pure competition that have developed during the nineteenth century have had as their object the elimination of just such risks. The risk from lack of knowledge of the future demand has to some extent been eliminated in the Co-operative Stores. This is chiefly due to the fact that the store has a large regular clientele, and deals mostly in articles for which there is a regular demand. It can therefore anticipate with considerable accuracy. The risk arising from the lack of centralized knowledge between rival firms, has been eliminated by some form of combination between firms, which, while it may leave them still competitors, arrives at some understanding as to the allocation of the market, and prevents over-supply.

But the capitalist-employer did more than use his capital and risk loss. He organized the business; brought together the workers, decided what was to be produced, and how and in what quantities it was to be produced. And he received no other payment for this work separate from his general income known as profits. To-day, in the company form of organization, the organizers of the business, the men who perform the work that used to be done by the employer, are paid in a fixed salary and not by any variable sum like profits.

If a business is to continue it must make a profit. But profits, unlike payments for other factors of production, are a highly variable form of remuneration, depending as they do on the difference between total receipts and total outgoings in a business. Differences in efficiency of organization, and in anticipation of demand, enable one firm to make larger profits than others, and such differences in efficiency must always be present. Under absolute freedom of competition they are reduced to a minimum. But absolutely competitive conditions seldom exist. For a time one firm will have possession of a patent process, or a new material which other firms do not possess, and which gives it for the moment a differential advantage over the firms in the same industry. Whenever such a special advantage, or a semi-monopoly, exists, the profits of that firm will, for the time being, and until the patent expires, or other firms have discovered equally good machines or processes, partake of the nature of rent.

In profits, then, these elements may, but do not always appear : (a) a payment for risk ; (b) a payment for the work of organization ; and (c) a payment due to a temporary differential advantage in production.

CHAPTER XII

THE PAYMENT FOR LABOUR

The Labour Factor in Production

WE consider in this chapter the causes which determine the relative rates of remuneration paid to different individuals and in different occupations.

In ordinary economic life the workers consist of the following broad classes : (1) the organizers of industry ; (2) responsible officials—works managers, heads of departments, etc. ; (3) skilled workers ; (4) unskilled labourers.

These are all workers ; and it is becoming increasingly common for all of them to be remunerated either in wages or in salaries. In the type of business known as the private firm, the organizer of industry received a fluctuating income, known as profits, the nature of which was discussed in last chapter. But in the increasing company-form of business, even the organizers are paid fixed salaries. A wage bears a definite relation to the time worked, or the produce turned out, and it ceases when the work ceases. A salary is fixed for longer periods and is paid irrespective of the amount of work done in particular periods, and irrespective of sickness and holidays. From the point of view of the recipients, the difference is one of security. But the forces determining the amount of each are the same in kind.

Labour Cost

The object of the employer in preferring one system of payment to another, and generally in deciding what

wage to pay his workers, is to reduce his labour costs per unit of output. This object is not necessarily attained by keeping down the rates of wages. Low wages may mean high cost, and high wages low cost. Where wages are so low as to be insufficient to maintain the health and strength of workers, an increase of wages may lead to such an improvement in the productivity of workers as to lower the cost of production. And apart from the mere question of physical efficiency, the psychological effects of a high wage are important from the point of view of output.

Relative Wages

It seems obvious at a first glance that different rates of remuneration are paid for different kinds of work. But we must be careful to see that we take into account the total remuneration and not only the most obvious elements in it. In particular we must distinguish carefully between the wages, the total income, and the total net advantage accruing in various occupations.

Wages and Income.—(a) To be told that a certain artisan earns 50s. a week is to learn little of his real economic position. A wage of 50s. a week in 1919 is a different thing from a wage of 50s. a week in 1914; and a wage that is high for one country would be low for another. We must distinguish between *real* and *nominal wages*. What concerns the worker is not the actual number of pounds or shillings he receives (his nominal or money wages), but the extent to which that money gives him a claim over concrete wealth.

(b) Again, in comparing the wages paid by two occupations, it is not enough to see what a man can earn in them in an hour, or a day, or a week. A year's income is a more illuminating fact than a week's income. But for an adequate comparison we must take into account various factors. First, each industry has its life and health averages; the workers in one industry have a shorter working life than in another on account of

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strenuous work, bad conditions, or the prevalence of accidents. Secondly, some industries give more irregular employment than others. Unorganized dock-labour yields high day wages, but affords only two or three days' work in a week. To arrive at a just comparison between two occupations, we must therefore combine the average working life of the workers in each, with their earnings.

(c) In the next place, wages do not always cover the total earnings of an occupation. In agricultural labour wages are frequently supplemented by an agreed payment in kind—the free use of a house and so much milk and other produce. Free house, coal, and light, are frequently an element in a schoolmaster's income; and the Scottish minister receives, in addition to his "stipend," a manse, and a "glebe," or piece of land.

(d) The important matter to a working-class household is not only the earnings of the father, but the total family income. Some localities have therefore a special attractiveness in that they offer employment to the daughters in the family as well as to the father and sons.

Income and Welfare.—Wages and additional earnings make up the income a man enjoys from his labour; but there are many items, positive and negative, of a character that cannot be measured in money, which attract men to some occupations and repel them from others. Questions of social standing, of health, of cleanliness, have often a powerful influence. Most men would rather earn £300 in the sunshine than £500 in a coal mine.

The relative attractiveness of different occupations, then, is not a matter of mere wages. And when we balance all the positive and negative elements, the question arises whether Adam Smith was not right when he said: "The whole of the advantages and disadvantages of the different employments of labour . . . must, in the same neighbourhood, be perfectly equal or continually tending to equality."

The assumption underlying this statement, which Smith brings out later in the same chapter, is that "things were left to follow their natural course," that "there was perfect liberty," and that "every man was perfectly free both to choose what occupation he thought proper, and to change it as often as he thought proper." If we make an additional assumption, namely, that all men are equally industrious and equally capable, we have the conditions under which wages would tend to perfect equality. For if, under such conditions, the advantages of one occupation rose relatively to those of another, men would flow into the former, and this increased supply of labour would bring down its price again. The constant movement from one occupation to another would tend to preserve equality. Let us look at the facts of the everyday world which make for inequality of wages.

Causes of Inequality of Wages

The first most obvious cause of differences of earnings, lies in the nature of men themselves. Some are more industrious than others; will work longer and harder and more carefully. But if this explains why, in any one occupation, one man may earn more than another, it does not explain why one class of work is persistently remunerated more highly than another. For it is scarcely believable that all the "shirkers" go into the poorly paid occupations and all the industrious into the highly paid.

The root cause of differences in relative earnings is the immobility of labour in one of its many forms. This immobility of labour may be economic in character, or geographical, or social,

Economic Immobility of Labour.—In a primitive system of industry, where trades are not specialized, and where no special ability is required to enable a man to adopt any occupation, there would be perfect economic mobility. A man could drop one occupation and im-

mediately take up another which promised him greater advantages. Under a system of division of labour where each man is specialized this is no longer possible. But that does not mean that there is even now complete immobility between one occupation and another. (a) Immediate transference is seldom possible, except in entirely unskilled work. But transference may be effected in some cases in a few weeks or months. Many coachmen, who lost their employment with the reduction in horse-drawn vehicles, have learned to drive motor-cars; and although a certain degree of division of labour reduces mobility, a greater degree may again increase it. When processes have been reduced to a series of simple movements which are taken over by machinery, such machines may be used in the production of very different articles, and labour can thus adapt itself to rapid changes in demand. It was on this account that, during the war, women and unskilled men were able, after a short period of training, to perform work formerly confined to skilled engineers. (b) Where immediate transference is impossible, a man may still be induced to send his son into an occupation other than his own. (c) All such transferences, however, may be restricted owing to trade rules and usages.

The older form of Trade Union, which still survives in some industries, tried to limit the numbers of workers in certain skilled trades by insisting on a long apprenticeship, by demanding the payment of a heavy premium on entrance, or by limiting the proportion of boys to adults. In special times there may even be legislative restrictions on movement (for example, the restrictions on the transfer of munition workers during the war). Where such rules exist and are potent, labour cannot follow its natural course; and this lack of economic mobility prevents the existence of an equilibrium between the demand for and the supply of labour in different occupations.

Geographical Immobility.—Wages differ between rural and urban districts, between different parts of the

country, and between different countries. This may occur in the same occupation, as when a city joiner receives a higher wage than a country joiner (a difference not wholly accounted for by the difference in the cost of living). But it is more obvious in the case of different occupations followed by men in the same rank of life. The outstanding case is that of agriculture. On pre-war wage-levels, the man who in the city became an artisan, earning £2 or £3 a week, became in the country an agricultural labourer at 15s. a week. During the seventeenth century, the great improvements in methods of cultivation and transport increased our food supplies so much, that a smaller proportion of the population is now necessary to produce all we need. Hence the natural increase of the agricultural population (which is greater than that of a city population) has been far too great to supply the needs of agriculture, and rapid as the movement from country to town has been, it would have been far more rapid if labour had been perfectly mobile, geographically. Indeed, where alternative occupations have been open within easy reach, as in Lancashire, the agricultural population rapidly diminished, and agricultural wages were high in comparison with other parts of the country. Geographical immobility may be increased by legislation, as it was by the Acts of Settlement in the seventeenth century : but every advance in means of transport and communication, and every increase in knowledge, makes this immobility less serious.

Social Immobility.—The greatest differences in the rates of remuneration of occupations are apparent in the case of the different grades of labour. Such grades are separated by barriers almost impassable not only to individuals but to classes. It is not only that the working man does not become a barrister ; but his son seldom becomes a barrister : each grade is recruited from the sons of men in the same grade, and there is little movement up and down between one grade and another. Hence

those grades in which the numbers are small tend to remain small ; and those which are crowded to remain crowded ; and the difference between them is even accentuated by the fact that the natural increase in numbers (*i.e.* the difference between births and deaths) is larger in the lower grades than in the higher.

Why does not the son of an artisan become a lawyer or an administrator ? To enter the higher professions demands a costly education, social standing, influence, and the feeling that it is as natural to become a lawyer as to become a greengrocer. Such barriers do tend to break down. Free education enables a few to rise. But the way up is only a "ladder," or, as it has been more appropriately termed, a greasy pole ; and if mobility is to be perfect, we want neither a ladder nor a pole, but a broad road up and down which each will move according to his ability and choice.

Leaving now this question of relative rates, we have next to ask how the actual wages in any occupation are determined. We shall briefly examine several theories that attempt to account for the facts.

The Wages Fund Theory

What we have seen of the influence of mobility suggests that the supply of labour has a great influence in determining wages. The Wages Fund theory held that the average wages paid in an industry depended on two things ; first, the supply of labour in the industry, and, second, the wages fund. This imagined wages fund was a portion of capital : it was at any time fixed in amount, and unconditionally devoted to the payment of wages. From this conception it followed (*a*) that, given a certain wages fund, the general level of wages in an industry (or a country) depended entirely on the number of labourers in that industry or country ; and (*b*) that, given the total labouring population and the total wages fund, an increase in wages in one industry could only

be obtained at the expense of a decrease in other industries. The importance of the theory lay in its practical results. On its authority, it was argued that the only way to improve wages was to reduce the number of workers either by emigration, or by a reduction of the birth-rate; or in particular industries by restriction of the numbers allowed to enter the trade.

As the theory was stated, it is difficult to find any meaning in it at all, since it compares two things, capital and wages, which, stated *simpler*, are incomparable. Capital is a fund; wages is a flow of wealth; and unless it is stated for how long the fund of capital is destined to supply the flow of wages, the comparison is meaningless. We can of course give definiteness to the statement by saying that there is at the beginning of a period—say a year—a fixed fund of capital to be devoted unconditionally to the payment of wages for that year; that there is a certain number of labourers among whom the fund is to be divided; and that the general rate of wages depends on these two facts. But so stated the theory either becomes a truism or entirely false. From the point of view of arithmetic it is a truism, and not worth stating. But as an attempt to explain how money wages are determined it fails. For there is no fixed and unalterable fund out of which wages are paid, and by which they are determined. The theory misses the point that the source of wages is not an independent fact, but is affected by conditions of productivity, among which the number of labourers is one. The source of wages in an industry is the product of that industry; the source of wages in general (as of every other income) is the national income. Both of these are capable of expansion. An increase of labourers in an industry then may, and often does, mean not the overcrowding of that industry, but increased productivity and an increased flow of wealth out of which both labour and capital can draw a larger remuneration.

The Subsistence Theory of Wages

According to an older theory (which followed from the Cost of Production Theory of Value) the wages of labour are determined by the cost of subsistence of the labourer. If at any time wages happened to rise above this level the labouring population would increase and so wages would again be reduced to the subsistence level. If on the other hand wages fell below that level the labouring population would be reduced in numbers, by actual starvation or by a falling off in the birth-rate, and the scarcity of labour would again cause wages to rise.

There was every reason for holding such a theory as this at the beginning of the nineteenth century. But it rests on the false premise that an increase in wages leads to an increase in the birth-rate, which, as we have already seen in Chapter I, is contrary to the facts. And the theory is weak in that it fails to square with two things: (1) the obvious differences of wages in different occupations; and (2) the increase in the real wages of labour during the nineteenth century. Supporters of the theory have tried to fit it to the facts by making the term "subsistence" elastic enough to include not only the cost of keeping the labourer alive, but of keeping him efficient for his work; and accounting for differences in wages by the fact that in certain occupations more food, or rest, or recreation is necessary than in others. But if we substitute "usual standard of living" for "subsistence" in the statement, we simply push the explanation further back: we have still to account for the fact of different standards of living in different occupations. And if we adopt "cost of efficiency" in place of "cost of subsistence," it still remains to explain why on any reasonable estimate of an efficiency standard, unregulated wages are frequently below the standard.

The Productivity Theory of Wages

Recent theories of wages lay stress on the idea that the wages of labour are determined, not by a fixed fund of capital, but by the productivity of labour itself, in co-operation with capital. The product of industry is a flow of goods, and it is out of this flow, which expands or contracts with the productivity of labour, that labour itself and all other factors of production are paid. The amount going to labour as wages then, depends on two things :—

- (a) The value of the products of the factors co-operating.
 - (b) The shares of the total taken by the other factors.
- (a) The value of the total product depends obviously on its amount, combined with the value of the unit.
- (b) The share of the total product which comes back to the several factors is more difficult to understand. Let us look at a single business and see how it acts there, assuming, as we have done throughout, the existence of competition. At the centre of the business is the organizer, who brings together the factors of production, in their several kinds and proportions, and seeks to supply a particular commodity to the community at the greatest possible profit to himself. Let it be noted that his profits are the difference between the value of his output and the aggregate costs of production ; and that for him as an individual, the price at which his goods will sell, and the price at which he can buy his materials and hire labour and capital, are fixed. He cannot as an individual alter them. His opportunity for profits lies, therefore, not in increasing price or reducing the actual wages of labour, interest on capital, etc., but in increasing productivity relatively to costs. His work, in other words, is to conduct his business in the most efficient possible way. Thus, in view of a certain anticipated demand for his products, he will weigh the advantage of engaging more labour. He will estimate the

value to him of that labour in the way of added output, and he will be able, therefore, to pay to the labourers of any class the value of the product attributable to them. He will do the same with capital ; and he will also weigh against each other the advantage (from the point of view of productivity) of borrowing so much more capital at the ruling rate of interest, or hiring so much labour of a certain kind at the ruling rate of wages ; and he will act according to his conclusions.

All employers in the same industry are making similar calculations with regard to similar kinds of labour. Their cumulative effect has determining results on the remuneration of the various classes of labour in such industry. Where the demand for its products is on the decrease the value of the product of such labourers will fall, and employers will interpret this in a reduction of labourers, or a reduction of the wages offered. With an increase in the demand for the product, the opposite tendency will show itself, and wages will rise. Wages, then, depend on the productivity of the employee as interpreted by the employers ; and since employers are in competition with each other for labour, the worker will get his productivity value.

Two points have thus emerged as affecting wages : (a) the total production of wealth in the industry (or country) ; and (b) the scarcity or plenty of the various kinds of labour in view of the demand for them. But there is one other factor of importance, namely, the relative plenty or scarcity of the different factors. A good workman with few or antiquated tools cannot produce as much as he might with up-to-date appliances. The productivity of labour depends on the relative supply of labour and of capital goods. Where labour is over-plentiful relatively to the supply of capital, some labour will be put to its lowest uses ; and the productivity on the whole will be small, and therefore its wages will be low.

To summarize : We have seen in this chapter that

the differences in relative rates of wages arise largely from the immobility of labour which prevents the interchange of the labour of different occupations or grades. Consequently the problem of actual wages is different for each class of labour. Under competition the wages of the workers in a class tend to equal their productivity, which, in turn, is affected by the demand for their produce, the relative scarcity or plenty of labour in relation to that demand, and the relative scarcity or plenty of labour in relation to the other factors of production.

A few words must be added to bring these explanations into line with the fact that in the ordinary industrial life of to-day wages are not settled under conditions of pure competition.

The Effect of Trade Unions on Wages

As one man against another, the capitalist is in a much stronger position for bargaining than the labourer. The peculiarities of labour, distinguishing it from other commodities (which we discussed in Chapter VI), make it impossible for the labourer as an isolated individual to stand out for wages which would procure him a higher standard of living. If his works stand idle, the employer may lose custom, and he suffers the absolute loss of earnings during the period of enforced idleness. But at any rate he does not starve, and does not see his wife and children starve.

It was to remedy this weakness of labour as a bargainer that the Trade Union movement started. In its history Trade Unionism has developed two lines of activity. It has built up funds for the mutual benefit of its members, in sickness and unemployment; and it has developed economic activity, substituting the collective bargaining of an organized class for the individual bargainings of isolated workers. Without the former the latter would have been impossible.

The productivity theory of wages shows that the employer can give as wages to a class of workers the

value of the productivity of that class. Whether he will do so depends on the power of the labourer to stand out for that rate of remuneration. Among unorganized labourers that is seldom possible; the individuals compete among each other for work and their weakness as bargainers makes them accept what is offered rather than starve. The effect of Trade Unionism in industries where it exists is to enable the combined workers to secure in wages the full value of their labour.

Can it do more? There are grounds for believing that it can. During the nineteenth century the working classes, influenced by better education, and by their growing experience of the comforts and luxuries of the higher classes, have continually been reaching after a better standard of living, and Trade Unions, by bringing pressure to bear on employers, have been able to obtain for their members this higher standard. If this result has been reached at the expense of the shares of the factors of production (capital and organization) it would seem, on theoretical grounds, that it would have the effect of driving capital out of the industry, and so reducing wages again to their old level. But this does not necessarily follow. In answer to a forced increase of wages the employer will be induced to look to improvements in his factory, and readjustments of capital and labour power; and the increased value of output resulting from the improvements will be sufficient to reimburse him for his extra cost in wages. And again, where such improvements are not possible, another alternative may be open. The manufacturer may get the increased wages out of consumers by raising the selling price of his produce. This will be the easier alternative where the whole of the labour producing such commodities in a country is thoroughly organized. In either case, after such readjustments have been made, the remuneration of labour again is measured by its productivity.

Thus, while *in the long run* the wages of a class of labour are measured by the value of the product attributable

to that labour, in the *short period* organized labour may be able to force wages above that limit.

The Distribution of Wealth among the Factors of Production

What has been said in the foregoing chapters serves to explain the relative incomes derived from different units of land, labour, and capital respectively. But it has not directly touched the question of the aggregate shares going to land as a whole, labour as a whole, and capital as a whole; or of the relation between the average income from labour, from land, and from capital. Yet the problem has been indirectly solved.

The average rate of wages is simply a question of the aggregate share which labour takes out of the national income, combined with the number of labourers. Hence a rise in the average rate of wages may coincide with a rise, or a fall or an absence of change in the proportion of the national income which comes to labour as a whole. In other words, the fact that wages as a whole have risen over any given period, does not necessarily mean that labour is taking a bigger proportionate share of the total than it did. It may mean, (a) that while its share has remained constant or actually decreased, the number of labourers has decreased, and each therefore is getting a bigger wage; or (b) since the total national income out of which all factors draw their payment is itself capable of expansion, it may mean that each factor is getting a bigger absolute share than it did. Similarly a rise in the rate of interest or of profits is not necessarily at the expense either of the average labourer or of labour as a whole.

But what determines the aggregate share of labour as a whole, capital as a whole, and land as a whole? From our discussion of the productivity of factors in the present chapter, it will be obvious that the aggregate share of each depends on the demand for it relatively to the

supply of it. Consider therefore two cases. (a) Taking only the two factors, labour and capital: if we assume that the conditions of demand remain constant, an increase in the total available capital relatively to the total available labour will make labour as a whole more productive and increase the *absolute* share it receives and therefore also the average wage of labour. But how that will affect the *relative* shares of labour as a whole and capital as a whole depends on circumstances. For the increase in the productivity of labour will have increased the total national income, and therefore capital may benefit equally with labour. (b) On the other hand, if we assume that the supplies of labour and capital remain constant while demand alters, then an increase in the demand for labour will result in an increase in its value relatively to that of capital, and therefore labour's proportion of the total income will be greater than that of capital.

CHAPTER XIII EXPENDITURE

The Use of Income

IT is not given to the individual to spend his income wholly as he will. Some part of that which he earns he must, if he is a member of an organized community, hand over to the community in the form of taxation. The remainder is his to do with as he likes—within the limits imposed by law and public opinion. There are three ways in which he may use it: (a) He can *save* it. The conditions and effects of saving we have already considered. (b) In the second place he can hand over part of it to others, either by *gifts* or by gambling. The economic effects of particular gifts are sometimes of great importance; but they are not sufficiently general to make any brief abstract treatment of them profitable. (c) Lastly, income may be put to its normal use in *consumption*. The kinds of things a man consumes have important bearings both on his own welfare and on that of the community. The wider issues in the former case are matters for the moralist. From the narrower economic point of view two observations must be made. In the first place, economic theory assumes that the individual so distributes his income over its various uses that it yields him the maximum satisfaction. In actual life men do not always exhibit such unerring judgment. In ordinary purchases they seldom take the trouble to seek out the most advantageous market. Further, they may make bad mistakes in their choice of utilities. A temporary desire may override one's better judgment. A man, for instance, with a moderate income, may pur-

chase a motor-car and live to regret it. Those facts mean that the welfare of a man depends not only on the size of his income, but on his judgment in spending it.

Secondly, we often put our income to uses, dictated not by our own personal needs, but by our desire to imitate the standard of living of others. We buy a motor-car not for the pleasure of riding in it, but for the pleasure of being seen riding in it. Where this class-influence interferes with expenditure on health and efficiency—as when a factory girl underfeeds in order to buy a dress which is in the fashion—our income is not put to its best economic uses.

The Social Effects of Consumption

The particular things a man consumes affect the economic welfare not only of himself but of the community; and, from this point of view, it is possible to draw a distinction between good and bad spending. The attempt is necessary in view of the common assumption that all expenditure is good because it "puts money into circulation" and "gives employment."

(a) *The Test of Employment.*—In the above assumption there are several implied fallacies. The first is the belief that what is not spent in consumption is useless. In these days of opportunity for investment, the real alternative to consuming is, not hoarding, but saving, which means not idle money but money productively used. The only ground, therefore, for attributing a general superiority to spending is that wealth used for consumption is better employed than wealth used in production. No general statement of this kind can be made. We must therefore turn to consumption and try to distinguish types. If, as is asserted, expenditure on consumption goods "gives employment" it does not follow that all expenditure gives equally beneficial employment or is of equal social advantage. The demand for consumption goods is a demand for different grades, qualities, and proportions of labour and capital. The things

I purchase may be the product of "sweated" labour, or of labour employed under Trade Union conditions, and it cannot be held to be immaterial to society which of these purchases I make. Unfortunately the consumer is seldom aware of the conditions under which different articles are manufactured; and he is therefore almost powerless to apply such test to his expenditure. The community as a whole must approach this problem from the other end by making employment under bad conditions of pay and surroundings illegal.

In the second place, a demand for necessities is (other things being equal) preferable to an equal demand for articles of luxury or passing fashion; since industries producing staple articles are more likely to give permanent and regular employment both to labour and to capital. In an abnormal time like the present, when there is a need to increase our exports and decrease our imports, expenditure on luxuries, many of which are imported, should be rigidly curtailed.

Thirdly, it is frequently assumed that consumption by the rich, being on a large scale, is consumption that would not have taken place but for the existence of great inequalities of income, and that the existence of such inequalities is therefore an ultimate benefit to society. The same argument is applied to saving. To quote from a large ironmaster, "If I did not get richer, I should not have money to invest; if I did not have money to invest I could not improve my works; if I did not improve my works, I could not give you employment." The fallacy in both cases is the same. The assumption is that wealth, whether as income or as capital, would be less than it is but for inequalities of distribution; it ignores the possibility of a more equal distribution of the same wealth, and the use of it by the many instead of by the few.

(b) *The Test of Permanence.* Consumption has important social bearings, secondly, because of the nature of the goods which are consumed.

It is obvious that in the case of the individual so long as the needs of physical health and strength are not met, expenditure on luxuries and even on comforts is wealth badly applied. What is true of the individual income is true of the national income taken as a whole. So long as any section of the community is underfed or underclothed, the nation suffers from badly directed consumption. It is important therefore that the members of the community should be able to earn an income large enough to provide the things necessary for efficiency, and that this income should be devoted first to objects making for health and strength.

The minimum for efficiency is no fixed amount. It is not to be confused with the amount necessary to maintain the traditional standard of life. The efficiency standard of any class is the amount necessary to maintain that class in health and strength and to bring up a new generation to replace it. It is a standard which, in the matter of nourishment at least, could be roughly measured for an average family in a given class and in a given district. For a manual labourer with a wife and family of three children, in the city of York, it was measured by Mr Rowntree for 1914 at 35s. 3d. a week. With prices in their present state of flux no useful equivalent for that sum can be estimated for post-war conditions.

But the efficiency standard necessarily varies with classes. When work involves mental or nervous strain, there is a need for a higher standard of living if productive efficiency is to be maintained; and the professional man has not only to maintain his intellectual as well as his physical efficiency, but also to bear the cost of educating his children up to the age of 21 at least if they are to replace him in the same class.

Available data are insufficient to show the cost of efficiency in different classes: but they are sufficient to prove that many people earn incomes below the efficiency minimum, and the facts lead to definite con-

clusions as to expenditure. In the post-war months the need for curtailing expenditure on luxuries was admittedly great in view of the unfavourable exchanges. But though the need was more pressing then, it was not more real than at any other time. In all consumption wealth is used up, and if it is used up in luxury forms it cannot be used in necessity forms. All consumption involves the use of capital and labour; and if they are devoted to the production of luxuries they are not being devoted to necessities. Necessaries are therefore scarcer and their prices higher than they might be. This would not matter if our wealth were sufficient and so distributed as to provide the goods necessary for efficiency for the mass of the community. But we have never reached this ideal condition. In 1913 the total income according to Professor Bowley was £2250 millions, and the average family income, rate and tax free, about £180.

Assuming, however, that this standard of efficiency has been reached and passed, there are two principles which might guide us in the expenditure of the surplus. First, while all consumption uses up wealth, the rate at which wealth is used up is not always the same: and that expenditure is preferable which involves goods of a lasting kind as contrasted with those which "perish in the using." A house is a better form of consumption than a bonfire; and a beautiful and lasting piece of furniture than a roomful of gimcrack products. The wealth of the world is not yet so plentiful that we can afford to put it out of existence more rapidly than necessary.

Secondly, forms of consumption that gratify only selfish desires are inferior to those which can be enjoyed socially. Here the economic consideration almost gives place to the ethical. But it is sound economics as well as sound ethics to insist that in a world which is still poor, such wealth as we have should be used to satisfy as many people as possible. A public park is

a better piece of wealth than the park in the private grounds of a castle. Few individuals can make choice between two such expenditures: but the progressive state will furnish from its revenues as many as possible of those forms of wealth which provide the means of health and recreation for its citizens.

Compulsory Expenditure

Out of his income the individual is compelled to pay certain contributions to the State in the form of taxes for local and national purposes. The justification for these contributions is that the existence of the State is the condition under which the individual can make any income at all, and that only through its activities can he retain and enjoy what he has made. But to carry on these activities the State requires a revenue. This it makes partly by conducting business enterprises and owning property; but the bulk of it comes from the contributions of the citizens.

Some of these services performed by the State are definite benefits to the individual, and are paid for as such in the ordinary way, namely, by a *price*, where the service is economic in character (as in the tramway services): or by a *fee*, where it is not primarily economic. In both of such cases the individual need not pay the contribution if he does not avail himself of the service; but if he does, what he pays bears some relation to the benefit he receives.

But most of the services performed by the State bring no measurable benefit to this or that individual. They are performed for the common good of the community. In return for such services the individual pays in *taxes*, the distinctive characteristics of which are two. First, they must be paid whether or not the individual avails himself of the services: a childless man has to pay education rates. Secondly, they bear no definite monetary relation to the value of the services rendered. A tax may therefore be defined as a *compulsory contribu-*

bution from the individual to defray the expenses incurred by the State in providing common benefits for all.

The Principle of Justice in Taxation

Taxes, then, are not assessed according to benefit received. But the distribution of the burden of taxation among individuals must be based on some principle of justice; and it is generally held that justice in taxation can best be secured by applying the criterion of contribution according to ability, which means in Adam Smith's words: "taxation in proportion to the revenues they (the subjects) respectively enjoy under the protection of the State." This aim may be stated negatively, thus: "To induce equality of sacrifice on the part of individuals."

The attempt to put this principle into practice has taken various forms. Apart from the poll-tax—which took absolutely equal contributions from everyone—two methods have been attempted. The aim of *proportional taxation* is so to arrange the various tax items that all individuals contribute a uniform percentage of their incomes. But five per cent. of a poor man's income is to him of greater utility than five per cent of the millionaire's income is to the millionaire. Proportional taxation bears more heavily on the poor than on the rich.

Progressive taxation is a nearer approach to equality of sacrifice. Its aim is so to arrange the whole taxation system of a country that the large incomes contribute a larger percentage than the small incomes. Few systems attain any great proximity to this ideal.

A cursory examination of our tax system, which is all that can be attempted here, shows that it attempts only roughly to embody the ideal of progression. We may classify our taxes as *direct* and *indirect*, the former being those whose burden is intended to be borne by those on whom they are levied; and the latter those in which the burden is expected to be passed on from

the original payer to others. (There are difficulties about any such classification, but they are beyond the scope of this book.)

The chief item among our direct taxes is the *Income Tax*, which came to be considered as a permanent item in our taxation only as late as 1874. At present the Income Tax, though extremely complicated, attempts roughly to embody the principle of progression. Incomes below £130 are exempt from contributions; incomes below £400 have an "abatement" of £120, and the tax is paid only on the difference. Smaller abatements are allowed on incomes up to £600 and up to £700, and above £700 the tax is paid on the full amount of the net income. Further, the rate of taxation per pound of taxed income increases by steps as the income passes certain points. Again, the idea of progression is helped out by the super-taxes, or additional taxes on incomes over £2500. Other items in our direct taxes, like the Death Duties and Legacy Duties, are "graduated" on various principles. But taking our direct taxes as a whole, one finds little ground for believing that they express with any degree of accuracy the principle of progression.

Indirect Taxes.—But even if we claimed that in direct taxation by itself the aim of equality of sacrifice was attained, there remain the indirect taxes, which disturb the balance. These are taxes on certain commodities like sugar, tea, coffee and cocoa, dried fruits, tobacco, wines and spirits, and playing cards. Many of these articles enter more largely into the poor man's expenditure than into that of the rich; and moreover, the rate of tax is independent of the quality and value of the article. There is therefore no attempt in these taxes to induce equality of sacrifice: and their presence prevents the "ability" principle from working out, unless we pretend that direct and indirect taxes are so carefully co-ordinated as to result in equality of sacrifice on the whole,—which is absurd!

In recent Budgets (not only during the war period, but in the years immediately preceding it) elements were introduced which indicate an apparent departure from the principle of ability to pay. Certain taxes are based, not on size of income, or amount of property, but on the source of income, or the way property is used. The differential treatment of "earned" and "unearned" income; the Land Values Duties first introduced in the Finance Act of 1909-10, and during the war the Excess Profits Tax, aim not at equality of sacrifice, but at altering the existing distribution of wealth, or changing social relations, or penalizing the owner of income made in what are conceived the less desirable ways. Taxation has been apparently used as a means of changing social conditions.

Other Principles of Taxation

The principle of equality of sacrifice is the most far-reaching theoretical consideration associated with problems of taxation. But considerations of practical expediency have to be considered.

From the point of view of the individuals among whom the burden of taxation is spread, a tax should be certain and not arbitrary, for uncertainty makes the burden heavier and tends to depress industry. It should be *convenient* in the time and manner of its payment. Indirect taxes have an advantage from this point of view, for the consumer can avoid purchase of the taxed articles. The tax, further, should be *economical*, i.e. it should take from the payer as little as possible in excess of the amount that reaches the Treasury. Lastly, the individual ought to be aware that he is being taxed, as every citizen ought consciously to contribute to the support of the State. Indirect taxes are in this respect far from ideal.

From the point of view of the State, taxes should be *productive*; they ought to be *calculable* so that the State knows how much they will yield and on whose shoulders

the burden falls; and the whole system should be *elastic* so as to be capable of meeting unforeseen expenditure.

Alongside of those positive principles, we must keep in mind the negative test: that no tax should be such as to diminish production or reduce the necessities of consumption for efficiency.

The Incidence of Taxation

We defined a tax as a compulsory deduction from income. But the degree of compulsion involved is variable. In Income Tax, the compulsion is obvious, except where a bad system of administration makes evasions easy. In the case of taxes on consumable goods the degree of compulsion varies with the nature of the taxed article. If it is a necessity, the consumer cannot escape payment; if it is a luxury, he can avoid paying by refusing to buy the article.

But even where the individual cannot escape paying the tax in the first instance he may still be able to pass on its burden from himself to others. This *shifting* of the burden of taxation alters its *Incidence*, and is one of the most complex problems of taxation. Here we can only indicate the nature of the problems of incidence.

If we could conceive of taxes as falling on the rent of land, the income from capital or the wages of labour, according to the classification adopted by Adam Smith, it would be comparatively simple to trace the ultimate incidence of taxes. A tax on pure economic rent, it is clear, could not be shifted, but must be borne by the owner of the land. For rent, as we have seen, is a surplus measured by the superiority of a piece of land over the marginal land which bears no rent and therefore would pay no tax. Hence the tax would not enter into the price of commodities, and therefore could not be passed on to the consumer. Now the nature of rent seems to make it an ideal subject for taxation on the further ground that, rent being a surplus, to tax it will not check production. On such grounds it has been suggested

that the whole of the revenues of the State should be raised by a "single tax" on land values. The objections to the proposal are bound up with the objections to the classification of taxes on the basis of absolute types of income. Actual rents are not pure economic rent, but may be partly interest on capital: and therefore to determine the incidence of a tax on actual rents is not the simple problem it appears at the first glance. A tax on interest, again, may be ultimately borne by some one other than the receiver of interest, if the result of the tax is to reduce saving or lead to the export of capital. In such cases it will lead to a rise in the rate of interest, which will mean increased prices to the consumer. But on the other hand, so far as interest is of the nature of rent, a tax on it would remain with the recipient of the interest.

The incidence of taxes on consumable commodities depends on a complex set of circumstances. One guiding conception is that of the elasticity of demand. Where demand is elastic, an increased price due to a tax will reduce purchases, which may lead the producer to keep the price at its untaxed level. In that case the burden of the tax is borne, not by the consumer, but by the producer.

The Source of Taxation

We have spoken throughout of taxes on land, property, etc.: but it must be remembered that taxes are paid not by things but by persons, and are in practically every case paid out of the person's income. Whether in exceptional circumstances the raising of State revenue deliberately out of capital is justifiable, is a practical problem raised by the war which up to the moment of writing has been generally answered in the negative. The argument for a "levy on capital" is based on the general ground of national urgency and of the grave alternative of an extended period of high Income Tax. Against that argument it is pointed out that the seizure

of capital means a discouragement [to] future saving through fear of a repetition of the levy. This is not the place for a discussion of the problem. But it may be pointed out that it becomes a problem only in exceptional times. In normal circumstances it does not arise, because a taxation system could not be permanently based on capital levies. On the other hand, if the war had lasted thirty years and resulted in a debt of corresponding size there would have been no alternative to a capital levy. The only question at issue now, therefore, is one of expediency. Have we passed the point at which the desirability of meeting the debt by taxes on income gives way to the desirability of a levy on capital?

has gained peculiar significance in its application to the possession of those large and costly capital goods which are necessary to production.

The resulting economic system is justified, in the eyes of those who justify it, on the ground that it yields the best results in the production of wealth and leads on the whole to a just distribution of the wealth produced. The argument is as follows.

The centre of the whole system is *price*, which is an automatic index highly sensitive to alterations in supply and demand. When the demand for a commodity exceeds the supply of it, price moves up, and producers are tempted to put out a greater supply in the hope of snatching profits. When supply exceeds demand, price falls and producers are warned from further production. Thus, through price, supply is kept in touch with the wants of the community. No artificial organization would be better than this; for the price index works automatically and swiftly.

Similarly, since wages are the price of labour, interest of capital and so on, we have in these various payments indices of the needs of the community for the services of these various factors of production. Hence two results follow: (a) these factors are induced to move where they are wanted, by the offer of higher remuneration, and thus the right kind of supply of goods is assured; and (b) since the payments indicate the needs of the community for these various factors the resulting distribution of wealth is based on a sound principle—namely, the performance of services.

This argument involves two main points: (a) that the wants of the community are correctly indicated by price; and (b) that the supply of an article follows the index of price. Let us examine these.

Wants and Price.—We saw in an earlier chapter that in the case of a single individual value is controlled by utility: he will give most—effort or money—for those things which have the highest utility for him. But

The Postulates of the System

PART III THE QUESTION OF THE SYSTEM CHAPTER XIV THE ASSUMPTIONS OF COMPETITION

THE economic system which we have been engaged in examining takes its character from the two principles on which it is based, economic freedom and private property. Neither of these is a universal principle. Both are human institutions, and capable of being altered or modified.

Economic freedom is the right of the individual, unhampered by restrictions on the part of any external authority, to seek wealth by methods of his own choice. In internal trade it flourished under the most favourable conditions in the England of a hundred years ago, when philosophers, economists and statesmen combined to preach the doctrine of *laissez-faire*, the ideal of which was complete absence of Government interference with industry. During the nineteenth century industry was subjected to ever-increasing restrictions. Nevertheless before the war, it was still true that over the greater part of the economic field, freedom and not restriction was the rule.

Private Property is the right of the individual to exclusive possession and use of wealth legitimately acquired, whether by economic means, or through inheritance or otherwise. In modern times this right

when we consider a group of persons, we have to take into account not only utility but means. For in the case of two persons with different means the same amount of utility is measured by different amounts of money. A rich lady would be willing to pay more for food for her dog than a poor man for food for his child. Hence the prices of goods are a measure not of wants simply, but of wants combined with means. In other words, what controls price is not wants, but demands. We have therefore no reason to believe that free enterprise automatically results in the production of the things most urgently wanted.

The same distinction must be applied to the claim that under free enterprise factors of production are rewarded according to their "services." What services? Only services to those whose wants are accompanied by ability to pay: and not in any sense necessarily those which are of greatest social importance. Wages and interest, like prices, are controlled by demands, not by wants.

Our first conclusion, then, is that price is an automatic index not of wants but of demands. Free enterprise is no Providence looking after the wants of humanity.

Let us turn now to the second half of the argument, that production automatically follows prices. The suggestion is that the system works smoothly, and supply follows demand with little friction. The main challenge to this view is the perennial problem of unemployment.

Unemployment

Unemployment we may take to mean the condition of labour which is unable to find work for which it is fitted, at a wage satisfying the normal standard earned by that labour. Where any want remains unsatisfied and any source of wealth unexplored, why should there be unemployment at all? The question would have

point if labour was independent and unspecialized, and had free access to the sources of wealth. But these conditions do not hold. Hence, in order to get the opportunity to work, not only must labour be willing, but other factors must be forthcoming.

But if this suggests that the unemployment of labour is due to lack of capital, it will have put us on the wrong scent. For when labour is unemployed, capital is unemployed also. We have to explain why, capital and labour both being available, they should fail to get productive work.

The Work-Fund.—There is a persistent belief that there exists at any time a fixed amount of work to be done, and that if this is overtaken too quickly certain workers will be left without employment. This belief has been behind the attitude of labour at various times towards two questions, the introduction of machinery and the increase of output. On the former question the general attitude has changed. But the principle of limitation of output is still widely enough held to be of serious practical import. The belief common to both is that anything which increases output dispenses with the labour of certain individuals and so causes unemployment.

The source of employment and of the demand for labour is not a fixed fund of work. The ultimate demand for labour lies in the national income. With every expansion in this stream of wealth, the incomes of individuals increase, and the increased incomes are either spent or saved. If spent, they make a demand for more labour and therefore give increasing opportunity for employment. If saved, they increase the supply of capital; interest tends to fall, and prices go down; and the demand for commodities and for labour is increased.

Thus every new machine, and every new process which leads to greater output, increases the national income and therefore increases the demand for labour. In

the long run, greater output comes back to the worker in the form of a demand for more labour.

But this is only in the long run, and there is a certain amount of justification for the attitude of those workers who object to increased output. In the first place, increase of output may, and often does, lead temporarily to the unemployment of some men. Secondly, while the introduction of a new machine does increase the demand for labour, the increased demand may not affect the labour in that industry in which the machine was introduced. Let us follow this second point.

A machine introduced, let us say, into the boot-making trade, lowers the price of boots from 30s. to 25s. Temporarily, the introduction of the machine displaced one per cent. of the wage-earning bootmakers. Will they be reabsorbed? The answer depends on the effect of the lowered price on the demand for boots. (a) If that demand is elastic, lowered price will lead to an increased demand, and some or all of the labour will be reabsorbed. (b) If the demand is inelastic the reduction in price will not lead to increased demand for boots: and the 5s. saved on each pair bought will be transferred to some other demand. That will result in an increased demand for *some* labour, but not for the labour of the unemployed bootmakers. Whether they will find work at all will depend on their mobility.

These facts suggest the line on which to seek the causes of unemployment. It is due primarily to the inability of supply, under the existing circumstances, to respond immediately to changes in demand. It is not that there is less than enough work to go round; but that there is friction in the economic machine. How does this come about? The answer has already been given in fragments in the foregoing pages. We shall therefore only bring the points together in a few sentences.

(a) The *Division of Labour* means that the full employment of specialized workers depends on the demand for

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their special kind of labour, and not on the general demand for labour as a whole.

(b) *Lack of information* may prevent workers from knowing where there is a demand for their special skill. The establishment of Employment Exchanges partly remedies this; but they cannot create a demand.

(c) Labour lacks complete mobility and cannot follow changing demand, either geographically or industrially.

(d) All supply must anticipate demand. Boys have to be brought up to industries which promise openings in the future, and the promise may prove illusory.

These facts taken together explain the lack of co-ordination between the demand for and the supply of labour. They also apply to capital, with whose defections, in addition to its own disabilities, labour has to reckon.

Types of Unemployment

The unemployment of labour is associated with different kinds of fluctuations in industry.

(a) One of the prominent features of modern industry is the occurrence of *cyclical fluctuations*. Industry passes through successive stages of great activity, decline, stagnation, increased activity, and so on round the circle. Two points are noticeable about the cycle. First, it is periodic: the full cycle occupies, with greater or less regularity, periods varying from seven to ten and a half years. Second, all industries are affected alike at the same time. We cannot examine here the various explanations put forward to account for the phenomenon. The most satisfactory begins with the fact of lack of organisation between the different sources of supply, to which attention has already been directed. Rival producers of the same commodity tend to produce more than the market can absorb at the price. This production involves considerable activity, but it is followed necessarily by falling prices, reduced demand, lack of

employment, and ultimately stagnation. On that supervenes a gradual clearing of the surplus, either by lowering price, or by a renewed demand ; trade again becomes brisk, and the round continues. But this theory by itself is not sufficient to explain why the fluctuations should take place simultaneously in all industries. Psychological influences and the credit system, which we cannot enter into here, would have to be taken into account.

(b) The unemployment associated with *seasonal fluctuations* in industry requires little explanation. The fluctuations are simply due to the fact of the seasons : fruit cannot be picked except when it is ripe. The unemployment associated with it is due to the lack of organisation. But different seasonal trades, whose busy periods fall in different seasons, might be fitted in with each other, and employment made continuous all the year round.

(c) Akin to seasonal trades are those which fluctuate from day to day owing to short period causes, like the tides, and which bring about the phenomenon of casual employment. These fluctuations give rise to the existence of reserves of labour ; for there must be sufficient labourers to meet the demand on the busiest days, and therefore there must be an excess on the slackest days.

Other kinds of unemployment are associated with industrial changes of one kind or another, such as accidents or bankruptcies ; or are due to the loss of time necessary between the losing of one job and the finding of another. In each case the fundamental cause is the failure of supply quickly to adapt itself to the changed demand.

This digression on unemployment has served to show that production does not necessarily accommodate itself quickly to changes in demand as indicated by prices and wages. And we saw before that price itself is not an infallible index of wants. Hence we must regard with

considerable doubt the easy optimism which suggests that freedom of enterprise leads to a just and smoothly working system. In the following chapter we shall see how the community has had to modify this freedom in its own interests.

CHAPTER XV

THE STATE AND ECONOMIC FREEDOM

State Interference

THE assumption of the identity of interest of individual and society, which is the sanction for complete freedom of enterprise, broke down in practice as on examination it breaks down in theory. But it was no academic conviction of the falsity of the thesis, but simply the stern facts of experience, that led to government interference in industry. At first stoutly resisted on principle, restrictions were found to justify themselves, and their extension is no longer resisted on principle but merely on grounds of expediency. To-day the question is not whether a measure of restriction is sometimes necessary or beneficial, but whether it ought to be applied in this or that particular detail.

Under normal peace-time conditions, then, the State has modified the purely competitive action of economic forces in relation to (a) production, (b) distribution, (c) organization, and (d) exchange of goods in foreign trade.

Interference in Production.—(a) The State has modified the free course of production in *the interest of the consumer*. The ground for such interference is the failure of the competitive system to meet efficiently certain needs of the community.

In theory, consumers always judge how best to spend their incomes. They discriminate qualities and prices, and select the seller from whom they get the "best value for their money." In practice, this perfection of judgment is prevented by lack of knowledge which, in

the limiting case, takes the form of inability to judge when goods are not only poor but harmful in quality; and the State has then to enforce on producers minimum conditions. Thus it has its food inspectors, and inspectors of weights and measures; and it insists on a certain minimum standard in the supply of such articles as milk.

Again, there are certain services, for which, in the general interests of the community, the need is urgent, but for which the necessary price would not be forthcoming. The wants of the community, in other words, would never become "effective demands" on the part of individuals. The State, therefore, provides such services at a price below the competitive price; and takes the balance from the community in the shape of taxation. Illustrations of such services are—the provision of educational institutions, and, at the time of writing, the provision of housing accommodation for the working-classes.

Thirdly, certain services would not be provided under private enterprise, not because they would not pay in the long run, but because profitable returns from such investments would be far distant and would not benefit the existing generation. An example is the work of afforestation.

Mention must also be made of certain services in which competition naturally gives place to monopoly apart from State interference. Such are the supplies of gas, water, electricity, and tramway services. From their nature such things must be supplied locally; and the distant competitor is automatically excluded. Further, within the local area, duplication of the service would be uneconomical because of the big initial capital outlay required and the necessarily limited area to be supplied. The result of free enterprise in these services, then, is the elimination of the weaker competitors and the establishment of a monopoly which can control prices and conditions of supply. Hence the State frequently steps in to exercise some degree of control

over the provision of these services—the degree varying from a limitation of profits, to the complete assumption of the enterprise by the State itself. In this country the tendency is for municipal services of this kind to be taken over by the Municipality.

Similar services, covering a wider area, are the provision of postal, telephone, and telegraph facilities, railways, and coal mines. They have this in common that they are national utility services, and when any question of individual or class interest as opposed to national interest is involved, the former must give way to the latter. Hence in every case the State exercises some degree of control over them. In the case of the telephone service and the postal service, which, to be efficient, must be unified, the monopoly is frequently taken over by the State; and in railways and coal mines some control is exercised over the efficiency of the service or the prices which the consumer has to pay.

(b) In the second place, conditions of production have been modified by the State in the *interests of the producers* (though with an eye to the general well-being of the community). Beginning with Factory Legislation applying only to women and children (considered exceptional because of their weakness as competitors) and confined to cotton factories, the interference gradually extended to cover practically all industries and all conditions, and to include the conditions not only of women and children, but of men.

The implication of all such legislation is that the system of free enterprise left to itself does not necessarily yield to the workers the minimum conditions of health, safety, and comfort which society holds should be available for every one of its members. But its extension is not a negation of the idea of competition; it only raises competition to a new level. The enforcement of regulations may, in the first instance, lead to an increased cost of production, but every additional cost is one which must be borne equally by all employers in a given

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industry. It becomes part of the general conditions of production under which competition acts. So long as such social legislation is confined to particular countries, however, employers in the more advanced countries may be at a disadvantage for competition in the world-market. The remedy lies in the internationalization of labour legislation, the first step towards which has been taken in the Labour Charter which forms part of the League of Nations.

Interference in Distribution.—In normal times State interference with the division of the product of industry among individuals is slight. But there are certain exceptions to the general rule.

(a) Even before the abnormal conditions of war time led to widespread regulations, minimum wages had already been fixed in several industries, definitely regarded as exceptional. These were the "sweated" industries which were brought under the Trade Board Act of 1909, and Coal Mining, legislated for in the Act of 1912. In the case of the sweat industries the assumption (which is fully justified) is that the workers are exceptionally weak bargainers on account of disabilities of age, infirmity, sex or domestic ties, and on account of their having to compete, as hand labourers, against factory conditions of production. Hence, unprotected, they received as payment a wage less than sufficient for subsistence, and less than the industry under compulsion could bear.

(b) Legislation for the provision of Social Insurance, whether against unemployment, sickness, old age, or accident, takes different forms in different countries. The insurance may be wholly provided by the State (as in the case of our Old Age Pensions) or partly out of funds contributed by the State, the employer, and the wage-earner. There is every reason why the community should bear part of the burden, since the insecurity of the worker is involved in the nature of the system by which the wealth of the community is produced, and

since the sickness of the worker, if it is ascribable to the industrial conditions under which he works, is a real part of the cost of production. But if these reasons lie behind the insurance scheme, an employer's contribution varying with the sickness experience of his industry, would be more just than the existing flat rate. Provision is indeed made under the Insurance Act for Insurance Committees to get damages from industries whose average sickness is excessive. But altogether, the scheme is not worked out to ensure fine adjustments.

(c) Lastly, the State makes provision for its economic failures under the Poor Law. The whole idea of poor Relief has in recent years undergone considerable revision; and there is a growing belief that State aid should take its place in a general scheme of social legislation, including the utmost possible elimination of unemployment; and as part of such a scheme, resort to it should be the right of every individual, and should not be associated with any stigma of pauperism. Against that view there is still a considerable body of opinion that holds that every receipt of relief lessens independence and self-reliance and weakens the character of the people. Between the two views there is a world of difference of outlook. The respective views attach themselves naturally to the socialistic and the individualistic philosophies as part of which they must be judged.

Interference in the Organization of Industry has been undertaken chiefly in connexion with the problem of unemployment. In the hope of speeding up the coincidence of supply and demand in the case of labour, the State system of Employment Exchanges was established in which employers in search of men, and men in search of employment, might be brought together. A well-devised system of exchanges might do more than this. It might help to solve the problem of casual labour if a determined attempt were made to give continuous work to some men instead of spreading work irregularly over all. The decasualization of labour was

indeed one of the original aims when the employment exchanges were devised; and it was supported by a clause in the Insurance Act penalizing employers who gave casual labour; but there is little sign of the employment exchanges having carried out the original intention with any degree of success.

In recent developments the State has shown its awareness of the need of external guidance for industry. In the matter of the prevention and settlement of industrial disputes little systematic work had been done by the State before the war. The establishment of Whitley Councils in several industries is still too recent for comment, but a great extension of activity in this direction seems imminent; the effect of which will be to substitute, under the *egis* of the State, a considerable amount of collective control of industry worked out by the common deliberation of all sections of producers, in place of exclusive control by the capitalist and employer.

Stages in Government Intervention

Where the State has stepped into the industrial field, its intervention has, as may have been gathered, reached a greater or less degree of completeness. In some cases the State leaves the whole of the management of business to the private employer or the Company and simply demands that the business be carried on under certain regulative conditions. Secondly, where private enterprise fails to furnish the community with some of the things it needs, the State may supplement private enterprise and enter itself into the competitive field. Thirdly, the State may assume the monopoly of certain supplies, carrying on enterprises like a private firm, but under conditions of monopoly instead of competition.

Much controversy has arisen round the assumption by the Government of economic functions. The whole question ultimately resolves itself into the problem of the socialization of industry—a problem too big and important to receive cavalier treatment. In its more

limited form the problem is whether an extension of State ownership to this or that industry would not be advisable. The arguments on either side are partly economic, partly political and moral. Those who favour the extension of State enterprise point to the success of public undertakings like tramways and waterworks. But it is pointed out in reply that all such services are peculiar in character, being natural monopolies, and that consequently they yield no argument for the substitution of government enterprise for competitive industry. In support of private enterprise, attention is directed to the incentive which the hope of private gain gives to efficiency; and to the bureaucratic and hide-bound character of government departments. On the other side is adduced the experience of Co-operative Societies and Companies, whose organizers, working for fixed salaries, are still as efficient as private employers working for profits. But the question is one which cannot be settled in the abstract; each industry and each State presents its own peculiar problems and technical differences; and each case must be discussed on its merits.

Free Trade and Protection

It remains to consider the interference of governments with the course of the exchange of products of international trade and industry. The main issues between the system of Protection and the system of Free Trade.

The general policy of Protection is the limitation of imports in the interest of the home producer, by means of taxes levied on foreign commodities as they enter the country. It is opposed to the policy of Free Trade, the essence of which is the absence of differential treatment of commodities, whether they are of home, foreign, or colonial origin. It should be noted that complete freedom of trade is not incompatible with a system of taxes laid on imports for the sake of revenue only; so long as such taxes are levied, not only on the imported article but on the same article produced at home. Thus a

Free Trade country may quite consistently tax foreign wines and spirits as they enter its ports, if it levies an equivalent tax on wines and spirits produced within its own area; or again, it may quite consistently levy a tax on imported coffee, if no coffee is produced at home. In neither of these cases is discrimination shown in favour of home producers; unless we seriously hold that the taxation of imported tea, for example, drives the consumer to mineral waters.

Few men will be convinced as to the merits of the respective policies by an appeal to economic considerations alone. The question has been inextricably bound up with politics, and it raises powerful individual and trade interests. Speaking broadly, Free Trade is the economist's policy; for it is the obvious policy when general economic considerations alone are considered. Protection is the policy of those who regard other questions as more important than the general economic welfare; either because they are actuated by considerations that seem bigger than the merely economic, as for instance, the need for national security; or because they are actuated by less worthy and more narrow and selfish interests.

The economic argument in favour of universal Free Trade is simple. It is based on two principles: (1) First, the economy of division of labour, whether applied to individuals or to nations. With this we have already dealt in Chapter II. (2) Secondly, the equivalence of exports and imports. Since goods and services exported balance goods and services imported, any restriction on imports necessarily curtails exports, and raises prices. Those two principles in combination give the general grounds for the belief in freedom in trade, and are a sufficient answer to the cruder arguments for Protection, such as the argument that the restriction of imports of foreign manufactures gives more employment for the home worker.

The worthy arguments in favour of Protection are

based on the conception that it is sometimes desirable, in view of circumstances partly economic, partly political, to give artificial support to certain industries which, left to themselves, would be unable to survive perfectly free competition. In particular, three forms of this argument must be noticed :

(1) *The Infant Industry Argument.*—This argument applies to young countries, or to countries trying to develop new industries. The argument, in brief, is that under perfectly free trade, even those industries for which the country is eminently suited, do not get a chance to develop. They are strangled in their infancy by the competition of the more mature industries of older countries. It is therefore advisable to give them protection in their tender years. When they become strong the artificial support can be removed.

Against this argument are advanced reasons, partly theoretical and partly based on experience. The danger is great that the industries selected for Protection may not be suited to the conditions of the country, and that the country may find itself committed to the fostering of industries which become more and more parasitic on the community. And from the experience of America, where the Infant Industry argument was most exploited, we know the difficulty of removing Protection when the infants have grown up. The stronger they become the larger become the interests demanding the continuance of Protection. Trade begins to pull the wires of government, and the whole political life of the country tends to become corrupt.

(2) *The "National Existence" Argument.*—Germany's protective policy was part of her preparation for war. Her argument, which can be applied to any country, was that purely economic considerations must come second to considerations of national security. The country must develop within itself all the industries essential to its existence, so that in time of war it is independent of external aid. This whole argument

stands or falls according as the country is to be organized for war or for peace. And it is difficult to see how any honest nation can at once be a signatory to the League of Nations and act in the spirit of the Balfour or Burleigh report.

(3) *The "Dumping" Argument.*—The chief argument that has been advanced in this country in favour of Protection is that it is the only means open to us of combating the dangers arising from "dumping" (see pp. 77, 78). The chief objection to dumping is its intermittency. The single manufacturer suffering under it has a grievance in any case, but from the point of view of general welfare, the case against it would not be strong if the foreign article were permanently sold at a lower price than the home-made article. But sooner or later the foreign manufacturer captures our markets, and as soon as this happens, up go his prices to the old level. We have lost our industry, and we have not gained in cheapness. And again, dumping is apt to be spasmodic only, and therefore to dislocate prices and to make our manufacturers timid.

This is probably the strongest argument for some measure of Protection. But even in this case, one would have to proceed with great caution. For one thing the extent of dumping is liable to be overestimated; and it is a matter of great difficulty to discriminate dumping from perfectly "fair" competition. Nor is it clear that Protection would stop the practice. For if it pays the protected monopolist to sell us goods under total cost, it might still pay him to sell them even in face of a protective tariff; especially as it is unlikely that the home producer would fail to take advantage of the tariff to raise his own prices.

However plausible the protective policy is in theory, the difficulty of erecting in practice a system which would be sound both economically and politically, has always to be reckoned with; and when we realize that at best foreign trade is a relatively small element in

our total trade, and that the utmost effect of Protection is much less, the wisdom of adopting a policy which inevitably gives rise to internal industrial jealousies and to retaliation on the part of foreign countries, seems doubtful.

CHAPTER XVI

THE REGULATION OF INDUSTRY IN WAR TIME AND AFTER

THE degree of State interference in industry described in the previous chapter had become the normal condition under which, in pre-war times, the economic life of the country was carried on. On the whole it left freedom of enterprise relatively unaffected as the principle under which the forces of supply and demand interacted. The minimum conditions of sanitation, health, safety, and leisure in industry insisted on by law, were felt as restrictions only by the sub-normal establishments; and served only as the block behind the wheel to prevent the vehicle of industry backing downhill. The majority of industrial concerns carried on their activities of buying, manufacturing, and selling under conditions³ in advance of legal requirements. The minimum wage regulations applied only to exceptional industries. No restrictions fettered the free movement of capital, whose mobility was such as followed from its own nature. In a word, the various elements making up the forces of supply and demand still acted in the main under their own natural laws. And just as the normal man is not less free because the State prohibits murder and theft, so the normal business unit lost nothing of its freedom of enterprise because the law insisted on certain minimum conditions of its activity.

On the other hand, before the autumn of 1914, economic freedom had begun to express itself increasingly under the form of combination, which reduced the area, if not the intensity, of competition. On the side of

labour, the Trade Union was an organization intended to increase the freedom of the wage-earner by the elimination of the crude competition of individual workers as sellers of labour. But powerful as the Trade Unions had become (in 1914 they embraced four million workers, or forty per cent. of the adult male manual working population) they fell far short of holding a complete monopoly of the supply of labour even in the most vital and highly organized industries. This was due to two facts: first, the enormous potential supplies of labour power which could be drawn from other sections of the community (as was illustrated in the railway strike of 1919); and second, the inherent inability of labour to stand out indefinitely for its own terms unless backed by much greater resources than it was likely to command. Monopoly conditions thus being absent, labour still reacted to the stimulus of economic forces. So far as labour was concerned the reign of competition had not been superseded.

Nor had the development of the method of combination among industrial firms abolished competition in the production of commodities. Pure monopoly, as already pointed out, exists only in the case of certain services which by their very nature admit of no dual source of supply; but in normal industry even the largest and most powerful combinations must always face the possibility of external competition, either of new firms, or of alternative commodities; and internally they result not in a diminution but in an increase in competition.

Thus in spite of development along the lines of association and combination, it was still true to say that freedom of enterprise and even competition was, up till the autumn of 1914, the dominant characteristic of industry; and that economic analysis, working on such assumptions, was still making use of a justifiable method. And indeed, the method will be obsolete and useless only if and when the production and exchange of wealth

and of the factors of production are so regulated that movement in obedience to economic forces becomes the exception rather than the rule. The nearest approach to such a condition of things in modern times was reached during the later years of the war.

The whole problem of the relation of the State to the economic life of the community resolves itself into a choice between two alternatives. Are we pragmatically to decide what is the most important economic end, and to order and arrange all our activities in relation to this end universally recognized as desirable? Or are we to hold that external interference is unjustified: and that the needs of the community should be left to express themselves through demand in its relation to supply? The choice is between a preconceived end into whose mould economic forces will be compelled to fit themselves: and the unfettered action of those forces. But this problem splits itself up into two, according as we hold that there is, or is not, a fundamental antagonism between these two alternatives. It is possible to argue that there is no fundamental antagonism, since in the long run the free action of economic forces will itself bring about the realization of any end which is universally conceived as desirable. On that assumption any interference is justified only for short-period objects, and should be removed as soon as possible. On the other hand, it may be argued that the antagonism is complete, that freedom of competition can only realize limited purposes, and that for the attainment of higher ends, such as social justice between the various economic classes of society, economic forces must be held in leash. The control of industry instituted during the world-war was undertaken from the former point of view.

The economic policy of the Government was dictated by the unique circumstances of war time. It sought to supersede the normal action of economic forces, not because these would not of themselves have brought about the desired results in time, but simply because

the element of time was important; economic forces are slow in their action, and the needs of the situation were urgent. The varying demands of the community normally reflect themselves in price which stimulates or discourages supply according as it is rising or falling; and in the long run the tendency is towards an equilibrium in which the amount supplied at a given price equals the amount demanded at that price. In the case of increasing demand the necessary augmented supply is forthcoming in two ways. At first the labour and capital already in the industry are stimulated to increased output. Later, if the increased demand is seen to be a permanent fact, new capital will be attracted into the industry; and youths will be trained to it in preference to other industries in which a similar increased demand has not appeared. Hence in time the whole industry will be raised to a new level and a new equilibrium will be established. The first of these effects may be brought about rapidly; but if the increase in demand is very great it will fail to be met simply by extra output on the part of already existing capital and labour. To meet the war demand for munitions and army stores, the supply would have been far from adequate if dependence had been placed on the existing agencies. The only alternative was to attract new capital and labour into the industries concerned; but that had to be done rapidly, while the natural economic forces move slowly and with some friction. Hence it was necessary to supplement the normal stimulus of increased demand by a certain amount of persuasion and ultimately of compulsion.

This Government intervention took several forms. Grants were made for the extension of factories and for the increased use of land for productive purposes; and on the other hand, labour was persuaded to relax many of its rules and usages (written or understood) which might have as their effect a restriction on maximum output. Compulsion followed persuasion. Factories be-

came "controlled establishments" in which employers became managers working under the direction of Government Departments or of Joint Boards, which decided hours of work, the kinds of machinery to be used, the processes of manufacture, and the kinds and quantities of articles to be turned out. In the controlled establishments freedom of enterprise was non-existent. Moreover, control was exercised not only *within* certain factories and industries, but gradually *over* the whole field of industry, with the object of confining productive effort to those purposes which were most urgent. The movement of labour from one form of industry to another was restricted by the introduction of the system of "leaving certificates"; capital issues were regulated; and such activities as the erection of private dwellings were prohibited except under special permit. Lastly, after using the methods of persuasion and control, Government took a further step and undertook the business of manufacturing munitions in its own national factories.

Thus to a considerable extent in all industry, and almost completely in the manufacture of munitions, control took the place of free competition as the factor regulating production; and to that extent during war time the normal assumptions of economic theory did not hold in the case of supply.

But it was not only in the sphere of production that natural forces were superseded by externally applied regulation. The distribution of goods among their various uses was also brought under control. This was in part due to the fact that the whole economic system is one, and it was impossible effectively to regulate production without first controlling the flow of the materials on which production depends. In this case also, the reason for interference was not that economic forces normally fail to adjust supply to demand, but that they do so slowly, while the need of the time was urgent. Normally, a given supply of materials is put first to its most important uses, and only after these have been

met to wants and uses of a lower degree of urgency. But the importance of a want is measured, under competition, by the price offered for the satisfaction of the want. The regulative factor is not want but effective demand. Now it was impossible in war time to await the slow action of this regulative principle. Effective demand was, therefore, superseded by the controlled direction of the flow of goods and those uses were given priority which best served the national need. The necessity of such control was emphasized by the shortage of materials and of means of transport, due to war conditions. The limited supply had, as quickly as possible, to be put to its best uses. Hence for the best utilization of the space on cargo steamers, certain imports were prohibited, others restricted; the supplies of goods already within the country were distributed between different industries according to the importance of those industries from the point of view of war demand; and within each industry firms were supplied with materials partly on the basis of their pre-war scale of output, and partly according to the class of goods they were engaged in producing.

But a second principle emerged in this connexion. Not only had war-needs to be met, but the civil population had to be served. Normally the pressing needs of consumers find their expression in increasing price which calls forth the necessary supply. But in war time supply was short, owing first, to the natural effects of the emergency; secondly, to the deliberate restriction of supplies for civil purposes on the part of the Government; and thirdly, to the limitation of prices which put the normal regulative principle, namely effective demand, out of action. The automatic regulator, therefore, being useless, it was necessary either to leave the distribution of the short supply to chance (or physical prowess), or to introduce some artificial regulator. The latter principle was adopted; rationing was introduced; and the available supplies were equally divided among

the people, each person counting as one, and nobody as more than one.

Thus in the matter of the distribution of goods two principles were to be seen. There was, first, a controlled distribution of material among their various uses on the principle of priority; and secondly, a deliberate rationing of the civilian population on the principle of equality. The justification in the first case was the belief that while economic forces would of themselves in time bring about the desired distribution, they could not do so with sufficient speed; in the second case the intervention was a consequence of the deliberate restriction of supplies and the deliberate limitation of prices. Given these, rationing followed inevitably.

We have therefore to look, lastly, at the reasons for fixing prices. The important consideration here, is that the Government policy was aimed at freeing the consumer from the tyranny, not of competition, but of monopoly. The alternative to control was not competitive but monopolistic prices. Under competition prices tend to come to the level at which they measure the cost of production of the marginal producer and any attempt at restriction of competitive prices by external authority will inevitably reduce supply by driving the marginal producer out of the market. But the peculiarity of the war situation was that, steady supply being cut off, the holders of stocks of short goods found themselves in a position (through no deliberate action of their own) in which they could fix prices at a monopolistic level, namely, at the level at which the number of goods sold, multiplied by the average price, brings the greatest net profits. Now under such conditions the restriction of prices is not accompanied by the same danger of falling supply. On the contrary, the monopolist finding price lowered will be forced to attempt greater output in order to benefit from the economies of large production.

Thus, in regard to production, consumption, and

prices, the policy of the Government in war time was based on the exceptional conditions of the time, and was intended to apply only so long as those exceptional conditions lasted. It implied no loss of faith in the efficacy of free economic forces, in normal times, to bring about the best results. In the case of production control was introduced to speed up a process which would otherwise have been slow; in the case of distribution of goods it was necessitated by the prior restriction of supply and of prices; and in the case of prices, it superseded, not competition but monopoly conditions which had themselves been made possible by restriction of supply. And, already (winter, 1919) many of the war-time restrictions have been or are in process of being removed; and control is continued only in those cases in which the existing conditions are a direct heritage of war time or in which war-time regulations have had results which must now be corrected by further regulation. Hence we are returning gradually but surely to some measure of the pre-war conditions in industry, in which, it is held, the unfettered action of economic forces can be relied on, given time in which to work, to bring about the highest welfare of the community.

The other point of view suggested earlier in this chapter is to the effect that even in the long run freedom of enterprise can never lead to the attainment of social welfare. The economic end and the moral and social end are irreconcilable, and since the moral end is the higher good, economic forces must be subjected to some one dominant interest which shall express for the time being the welfare of the whole community. And this subjection must be thorough. It is not merely that here and there the State shall intervene in a field otherwise left to free enterprise; but that freedom of enterprise shall be entirely superseded as the regulative principle of industry and the domination of a pre-conceived end substituted for it. And in support of the proposal it is pointed out that such supersession did take

place in war time, and can take place again so soon as we are unanimous in seeking one ultimate end.

The reply to the last point suggests the reply to the whole argument. In war time there was one need so urgent and overwhelming that, in spite of the harm done to other interests, important in a more normal state of society, it was worth while pursuing it at all costs. That it was a last-resort policy can be seen now that we have the problem of repairing the waste places left desolate by the pursuit of a single end, great and necessary as it was. But in normal peace-time conditions it is doubtful whether any interest could ever emerge to which all would direct their efforts with similar unanimity.

The problem has been wrongly conceived. Between freedom of enterprise and the social ideal as the regulative principle of economic life, there is not the fundamental opposition which has been imagined. The problem has been made insoluble by opposing the two alternatives of crude individualism on the one hand and absolute Government control on the other. There is a *via media*: and it lies in freedom interpreted not merely negatively as freedom from hindrances, but positively as the freedom of individuals to develop their economic functions in the service of the community. In this conception freedom and control are reconciled.

Mere individualism is not freedom whether it expresses itself in the *laissez-faire* attitude of the early nineteenth or in the syndicalism of the early twentieth century. That economic forces may work freely implies on the part of the State the promotion of the conditions of freedom. It must not merely stand aside and watch the struggle; it must suggest the things that are most worth struggling for, and endeavour to ensure that the various interests shall compete as nearly as possible on terms of equality. But the struggle will remain as the means by which the ends are secured. Historically, the test of an understanding of the meaning of freedom in industrial affairs came with the rise of Trade Unions.

At first associations of labour were declared illegal institutions, being considered to be "in restraint of trade," and crude individualism, the competition of isolated individuals, was lauded as the ideal method by which economic ends should be attained. But wiser counsels prevailed; and legal sanction was later given to the conception that the struggle between the individual workman and the individual employer was a struggle between unequals which led not to freedom but to slavery, and that freedom would be promoted by granting the right on the part of workmen to combine. This promotion of conditions of equality is the principle under which the functions of government in industry shall be determined. How much intervention this implies on the part of the State it lies outside our province to discuss. But whether much or little, within those conditions competition remains the regulative principle of economic life.

NOTE ON FURTHER READING

THE student will find no dearth of more advanced treatises on the general theory of economics. Where the material is so plentiful and so excellent, it is invidious to make distinctions; but it is suggested that a stimulating treatment of the subject will be found in Cannan's "Wealth" (with its supplement "Money: its connexion with rising and falling prices").

Marshall's "Principles of Economics" must be read.

On special problems the following works should be consulted. Each will lead the student on to further reading:—

- D. H. MacGregor: "The Evolution of Industry."
- J. A. Hobson: "The Science of Wealth."
- W. Smart: "The Theory of Value."
- T. N. Carver: "The Distribution of Wealth."
- A. L. Bowley: "The Division of the Product of Industry."
- H. Withers: "The Meaning of Money."
- S. and B. Webb: "Industrial Democracy."
- G. D. H. Cole: "The Payment of Wages."
- J. H. Jones: "Social Economics."

Important discussions of war-time problems and of questions of reconstruction are to be found in—

W. R. Scott: "Economic Problems of Peace after War" (Series I and II).

J. H. Jones: "The Economics of War and Conquest."

H. Withers: "Problems of War-Time Finance."

J. A. Hobson: "Taxation in the New State."

Government Publications (Reports of Commissions, etc.) yield data which cannot be neglected. Some of these are of only passing interest; but some have become standard works and should be known to every student of economics. Such, for example, are:—

- The Reports on the Cost of Living of the Working Classes (Cd. 6955), 1913.
 The Reports of the Poor Law Commission, 1909 (Cd. 4499).
 " Memorandum on Fiscal Policy and International Trade" (by Prof. Marshall. C 321 of 1908).
 The Final Report of the First Census of Production, 1907 (Cd. 6320), 1912.

Of more immediate interest are the following :—

- The Evidence of the Coal Commission, 1910 (Cmd. 360).
 Final Report of the Committee on Commercial and Industrial Policy after the War (Cd. 9035), 1918.
 Report of the Committee on Currency, 1918 (Cd. 9182).

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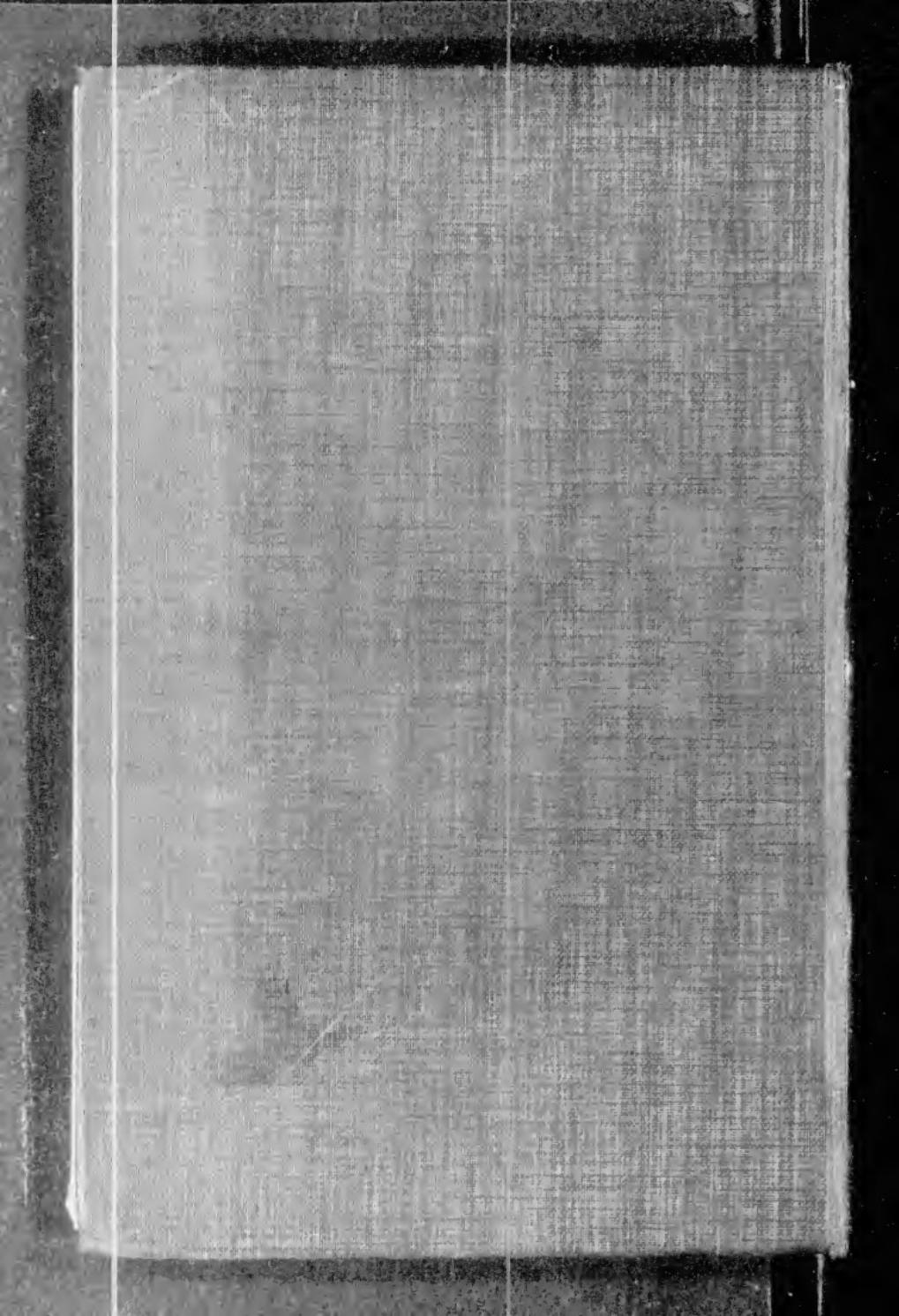
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